WITH SPECIAL SURVEY ON CHINA'S ECONOMIC ROLE

The Economist

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Politics this week

Sep 30th 2004
From The Economist print edition

Bloodshed in Iraq

EPA

Some 41 people were killed by car bombs in Baghdad on September 30th; 34 were **children** gathered to receive sweets from American soldiers. Two female Italian hostages in Iraq were freed; Italy's government denied paying a ransom. Two French journalists kidnapped last month were said to be likely to be freed, while a British captive, Kenneth Bigley, whose two American colleagues had been beheaded, was shown again on television, shackled and in a cage.

See article

The UN fretted that a proposed 3,000-5,000-strong African Union peacekeeping force would arrive too late, and with too few resources, to curb further atrocities in the Sudanese region of **Darfur**. Médecins sans Frontières said that the world's response to the ethnic cleansing of 1.5m Darfuris by the Sudanese government and its allied militias was “shameful”.

A tribal militia boss threatened “all-out war” against the Nigerian government unless it granted “autonomy”, ie, control of oil revenues, to the inhabitants of the oil-rich **Niger Delta**. The government started negotiations with him.

See article

Asia's bogey man

Taiwan's prime minister said the island might acquire missiles to counter a growing threat from China. China called that a provocation. Singapore's foreign minister accused Taiwan of pursuing a dangerous course towards independence. Taiwan's foreign minister deplored criticism from “a country the size of a piece of snot”.

See article

Pakistan's security forces killed a suspected terrorist, Amjad Farooqi. He was said to have been responsible for an assassination attempt on Shaukat Aziz, now prime minister, in July. He is also suspected of involvement in two assassination attempts on President Pervez Musharraf last December, and in the murder of an American journalist, Daniel Pearl.

Human Rights Watch, an America NGO, reported that the power of **Afghanistan's** warlords means that the election due on October 9th will take place in an environment of widespread intimidation.

See article

The prime minister of **Japan**, Junichiro Koizumi, reshuffled his cabinet. He put Heizo Takenaka, his chief reformist lieutenant, in charge of privatising Japan's post office, the world's largest financial institution.

See article

Adulterous union

Turkey's parliament adopted a new penal code, without a controversial proposal to criminalise adultery. This placated the European Commission, which is next week likely to recommend the opening of formal talks on Turkish accession to the European Union.

See article

Russia's government seemed finally to have decided to ratify the Kyoto protocol on climate change. Russian ratification would bring the protocol into force.

Slovenia's prime minister, Anton Rop, backed away from threats to obstruct Croatia's accession to the EU. But the row between the two was a reminder of tensions around the Balkans and also that candidates require unanimous support from all EU members.

To the relief of Chancellor Gerhard Schröder, **Germany's** ruling Social Democratics did better than had been expected in municipal elections in North Rhine-Westphalia, the country's biggest state. Another poor showing for the opposition Christian Democrats raised more doubts about the party's leader, Angela Merkel.

Swiss voters rejected plans to make it easier for foreign residents to acquire Swiss citizenship. The right-wing Swiss People's Party, now the biggest political party, had urged a no vote.

Hidden secrets

A report by the **FBI's** inspector-general found that the agency lacked the resources to analyse material gathered from counter-terrorism operations: thousands of hours of surveillance material has still not been translated.

Lawyers for John Walker Lindh, the "**American Taliban**" who avoided incarceration in Guantánamo Bay, filed a clemency request asking that his 20-year prison sentence be commuted. Meanwhile, an agreement was struck with Yaser Esam Hamdi, an American citizen held without trial as an "enemy combatant" since 2001, that allows him to leave the United States if he gives up his citizenship, renounces terrorism and promises not to sue the government.

Florida's Supreme Court said that Governor Jeb Bush acted unconstitutionally when he rushed through a law specifically ordering doctors to keep Terri Schiavo, who has been brain dead for 14 years, on a feeding tube, despite a lower court decision that sided with her husband (who wants the tube removed).

Hurricane Jeanne cut through central Florida, killing at least half a dozen people. It was the fourth hurricane to hit the state in six weeks.

Paramilitary manoeuvres

Talks between **Colombia's** government and the AUC right-wing paramilitaries, faced collapse after secret tapes appeared showing that one AUC commander, Salvatore Mancuso, was boycotting the talks, and the government issued arrest and extradition orders for another. The government's peace negotiator now insists that the AUC start disarming its 20,000 fighters before the talks resume.

Three **Argentine** schoolchildren died and five were wounded when a 15-year-old classmate opened fire with a handgun. It was the country's worst-ever school shooting.

Reuters

The estimated death toll in **Haiti**, two weeks after a tropical storm hit the north of the country, reached 2,400. Street gangs attacked aid workers and looted emergency supplies. The commander of the United Nations peacekeeping force that was brought in after the ousting of President Jean-Bertrand Aristide said that he still has less than half the troops he needs.

Chile's former president, 88-year-old General Augusto Pinochet, was set to

undergo medical tests on September 30th to check on his fitness to face trial for human-rights abuses. Under questioning by a judge, he denied complicity in Operation Condor, a murderous joint anti-dissident campaign pursued by six Latin American dictatorships in the 1970s.

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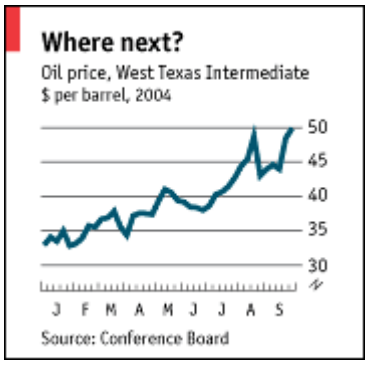
Business this week

Sep 30th 2004
From The Economist print edition

Prices continue to rise



Oil prices rose above $50 a barrel despite a pledge by Saudi Arabia that it would boost production by 15% to 11m barrels a day. But fears that exports from Nigeria would be hit subsided after tensions in the strife-torn oil region of the Niger Delta appeared to subside.

See article

Despite high oil prices the IMF predicted in its *World Economic Outlook* that **worldwide growth** would hit 5% in 2004, near a 30-year high. The Fund thought that rising energy costs would take their toll in 2005, but predicted growth at a still sprightly 4.3%.

See article

Russia's government sold its 7.6% stake in **Lukoil**, Russia's second-largest oil company, to **ConocoPhillips** for a little under $2 billion. Russia's hopes of getting more probably suffered because of the government's hounding of Yukos, Lukoil's main rival, which faces bankruptcy as a result of a tax probe. But ConocoPhillips is keen for a share in Russia's huge oil reserves and hopes to raise its stake to 20%.

See article

Electricité de France, France's state-owned power company, said it would sell its 2.3% holding in Total to buttress its finances ahead of privatisation, probably at the end of 2005. High oil prices have pushed Total's shares to a record high.

China's ability to involve foreign oil companies in gas projects took another blow. **Royal Dutch/Shell** and **Unocal** pulled out of a development in the East China Sea for “commercial reasons”. In August, a consortium led by Shell withdrew from a vast scheme to build a 2,500-mile pipeline across the country, saying that low gas prices in China would not provide sufficient returns for the investment.

Mexico's **Cemex**, the world's third-largest cement producer, agreed to pay £2.3 billion ($4.1 billion) for **RMC**, a British concrete firm. Cemex's shareholders reacted nervously to the hefty premium it will pay to expand its operations in Europe and mix it with the world leaders, Switzerland's Holcim and France's Lafarge.

See article

Directory marketing

VNU, a huge Dutch market-research firm, said that it would sell its telephone-directories business to two British buy-out firms, Apax Partners and Cinven, for *euro*2.1 billion ($2.6 billion). Apax has considerable experience with directories. It has pocketed big profits buying and selling Thomson Directories and a stake in Yell.com in recent years.

Merck announced the world-wide withdrawal of Vioxx, its blockbuster anti-arthritis drug, after new clinical trials showed that it raises the risk of heart problems. Vioxx's sales last year were $2.5 billion.

The American drug firm can ill afford their loss given its faltering product pipeline. Merck's shares plunged.

Microsoft and **Amazon** joined forces in the battle against spam. The software giant and the internet retailer filed several lawsuits that allege fraudulent use of the Amazon name for “spoofing”—sending deceptive marketing e-mails—and “phishing”—attempting to obtain credit-card and other personal details.

Watch this space

Sir Richard Branson, a train and plane entrepreneur, announced plans to take travellers a lot higher and a great deal more quickly. In association with Burt Rutan, a leading space-flight entrepreneur, and Microsoft's Paul Allen, **Virgin Galactic** will offer tourists the chance to boldly go to the edge of space—some 80 miles above the earth's surface—for $190,000 from 2007.

See article

Delta Air Lines announced its latest scheme to stay solvent. America's third-biggest carrier said that it would push through 10% pay cuts for executives and non-unionised workers and Delta's chief executive promised to forgo his salary for the rest of the year. But the airline is still negotiating to cut $1 billion from its pilots' wage bill.

Top of the flops

America edged ahead in its tussle with Japan to develop the world's fastest supercomputer. IBM claimed that **Blue Gene** had surpassed the previous claimant to the title, NEC's Earth Simulator with a working speed of 36.01 teraflops. Most computers flop only intermittently.

Cendant, a leading American travel and property firm, said that it would beef up its online offerings by paying $1.3 billion for **Orbitz**, an online travel agent owned by America's five biggest airlines, making Cendant the world's second-largest internet-travel firm behind Expedia.

Fannie Mae not

Fannie Mae pledged big reforms, including a large capital increase, in the wake of a regulatory probe which found that the American mortgage giant had wrongfully manipulated its accounts for some years. Meanwhile, the Justice Department began a criminal investigation.

See article

Citigroup juggled its top management. Sallie Krawcheck continued her rapid ascent in the world of banking, becoming chief financial officer and head of strategy, the number-two post at the huge financial-services firm. Todd Thomson, whom she replaces, dropped a rung to take her former job as head of Citigroup's investment-banking arm.

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The world economy

Scares ahead

Sep 30th 2004
From The Economist print edition

Can the world economy sustain its stunning pace of growth?

MOST people cannot remember when the world economy last grew so rapidly. The International Monetary Fund now reckons that real global GDP is likely to increase by 5% this year, its strongest pace for a generation. That growth has been led largely by the twin engines of robust consumer spending in America and booming corporate investment in China, but Japan's recovery has also been stronger than expected this year and even the euro area has perked up. Emerging economies as a group are enjoying their fastest growth for at least 25 years. It would hardly be surprising, therefore, if the world economy slowed next year. But will it slow gently or crash into a wall?

The IMF expects global growth to run at a still healthy 4.3% in 2005. Other official organisations, such as the OECD, the Federal Reserve and the European Central Bank, are also optimistic about the health of the global economy over the coming year. We hope that they are right. But history suggests that when things look so rosy, one should always ask “what might go wrong?”. There are four main risks: higher oil prices, a slump in America's consumer spending, a global house-price bust, and a hard landing in China.

Oil prices hit a record $50 a barrel this week, well above the average price of $37 on which the IMF bases its forecast. Oil matters less than it once did, and in real terms oil prices are still well below their previous peak, yet oil prices still have the power to hurt the world economy. If they remain at current levels or even climb higher, corporate profits and household real incomes will be squeezed. The IMF reckons that a $10-a-barrel rise would trim global growth by 0.6%.

Oil currently tops everybody's worry list, yet a more serious risk to the world economy is that over-indebted American consumers may be forced to tighten their belts. Consumer spending has already slowed quite sharply, but the conventional wisdom in America argues that the economy is merely going though a brief “soft patch”, from which it will soon rebound. Such forecasts assume that this is a normal recovery, even though the figures suggest otherwise. Since the trough of the recession in November 2001, America's labour market has seen its weakest recovery for half a century; total real wages and salaries have increased by a mere 3% compared with an average gain during the equivalent period of the previous six recoveries of over 10%. Yet even as wages have stalled, consumer spending has surged by 9%, supported by a massive monetary and fiscal stimulus. Tax cuts have lifted incomes, while negative real interest rates have encouraged households to borrow and have helped to boost house prices.

This stimulus is now fading, and both John Kerry and George Bush say they would cut the budget deficit by half over the next presidential term. Even if they fail, as seems likely, fiscal policy is likely to be mildly restrictive over the next year or two, at the same time as interest rates are rising. Household saving has fallen to a record low of less than 1% of disposable income and surely cannot fall further; more likely it will rise. In recent years, big gains in the prices of shares and, more recently, homes have boosted household wealth, so consumers have felt less need to save. Surveys suggest that they expect double-digit average annual returns from both shares and houses over the long term. This is wildly unrealistic; households are underestimating how much they need to save for retirement. Sooner or later they will have to save in the old-fashioned way, out of income rather than relying on capital gains. If the saving rate reverted to its long-term average of 8% over the next 5-10 years, a relatively gentle adjustment, consumer spending would have to grow 1% a year more slowly than income, the exact opposite of what has happened in recent years. In fact, there is a risk that saving could rise more swiftly, especially if overvalued house prices fall. More saving, at whatever rate, is bound to dampen growth.

That brings us to the third risk to the world economy, namely that the global house-price boom could turn to bust. Never before have real house prices been rising so fast in so many countries. In almost two-thirds of the world economy, housing markets look unusually frothy. Indeed, the world may face its first-ever global house-price bubble, and if it bursts it will hurt economies much more than the collapse in share prices did at the start of this decade, for houses are more widely owned than shares.

The fourth risk is that China's soaring economy might suffer a hard landing as its investment boom turns to bust. A slump in China would badly hurt the rest of Asia, and dent global confidence. China's GDP surged by almost 10% in the year to the second quarter, and fixed investment and bank lending are still rising too fast. The government is reluctant to use the usual macroeconomic policy tools of a market economy, such as letting the exchange rate rise and raising interest rates; instead it has relied mainly on administrative controls to curb lending and investment. Negative real interest rates are distorting market signals, and the bluntness of direct controls runs the risk that investment may mistakenly undershoot.

Global yin and yang

The finance ministers and central bankers of the G7 group of rich economies are likely to urge China to adopt a more flexible exchange rate when Chinese officials attend part of the G7 meeting in Washington, DC, on October 1st. This is the first time that China has been invited, a recognition of the country's growing economic clout. China is the world's second-biggest economy (measured at purchasing-power parity) and it has accounted for almost one-third of the world's real GDP growth over the past three years—a bigger share than America.

China poses a short-term risk over the next year or so, but looking further ahead that country's integration into the world economy is likely to remain a powerful driver of global growth. Our survey in the centre of this issue explores the many ways in which China's emergence is affecting the world economy. Currently, the most obvious feature is that the hungry dragon has a huge appetite for energy and raw materials. The 40% jump in China's oil imports this year is partly responsible for higher world oil prices. This is why one should not worry about both higher oil prices and a hard landing in China: if China's growth slumped, so would oil prices, unless the Iraq conflict spreads so widely as to threaten Saudi Arabian output. A slowdown in America would also push oil prices lower. In that event, cheaper oil would, in turn, help to offset the impact of weaker Chinese and American demand on Japan, Europe and other emerging economies.

There are also other positive factors that could help to offset a slowdown in America and China, and so prevent a global slump. While America's huge imbalances imply that its economy must eventually face several years of much slower growth, other parts of the world could surprise on the upside over the next few years.

It is fashionable to write off the euro-area economies as sluggish and unable to change. Europe's GDP growth has certainly been slower than America's in recent years—both in the 12 euro countries and in the rest of Europe. But this is largely due to weaker consumer spending, because European households have not borrowed up to the hilt and run down their savings. The average household saving rate in the euro area stands at around 10%, against less than 1% in America. Suppose increased liberalisation and competition in Europe's financial markets made it easier for individuals to borrow—as in America—while rising employment, thanks to continuing labour-market reforms, boosted consumer confidence. If so, then a fall in the euro area's saving rate could boost consumer spending and hence overall growth—exactly as it has done in America over the past decade. At present, most of the risks to the world economy lie on the downside—but not all.

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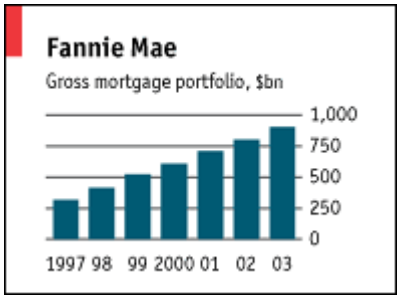
Fannie Mae and Freddie Mac

Houses of cards

Sep 30th 2004
From The Economist print edition

America's huge, government-sponsored housing lenders are a danger to its financial system



ANYONE worried that America's housing market might crash should be terrified about the news coming out of Fannie Mae, the country's second-largest financial company and the biggest player in its mortgage market. A scathing report published recently by Fannie Mae's main regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), portrays an institution whose accounting policies and internal controls not only are "dysfunctional and ineffective" but, worse, may have been skewed to boost its top executives' bonuses (see article). Fannie Mae's earnings and capital look sure to be restated downwards, exposing its financial fragility. This would be bad for any firm; in Fannie Mae's case, it is all the worse for being a direct product of the way the firm is regulated.

Fannie Mae has its origins in a federal government effort to revive America's collapsed housing market in the 1930s. It was set up to syndicate mortgage loans. At the time this made sense, but it no longer seems necessary. Today's sophisticated capital markets could easily handle even the huge volume of America's housing loans. Nevertheless Fannie Mae, and its smaller sibling Freddie Mac, have since grown into financial behemoths, bloated by special privileges. Fannie alone has accumulated a mortgage portfolio worth almost $1 trillion. Global investors hold a similar amount of the company's bonds. Fannie enjoys exemptions from the tax and capital standards applied to most banks.

High leverage, a vast loan portfolio and limp controls are a recipe for disaster that could extend far beyond Fannie Mae itself. Although now owned by shareholders, its debt is rightly regarded by financial markets as being backed by the federal government. It could not be allowed to fail. The government would have to step in to guarantee its financial viability to avoid a seizing-up of the mortgage market.

The investigation of Fannie was prompted by similar trouble last year at Freddie Mac. There was some hope then that the two were set for thorough re-regulation, but efforts by the Bush administration to do this were stymied by Congress. Fannie Mae is among the most politically astute operators in Washington, well connected to Republicans and Democrats alike via its board, consulting deals and contributions. In addition, politicians fear being portrayed as enemies of home ownership. Given both its advantages and its rapid growth, the problems reported by OFHEO are no surprise.

Time to abolish American socialism

Fannie Mae has responded to the critical report by agreeing to numerous special restrictions, many temporary. It will raise more capital; controls will be tightened; there will be closer scrutiny by OFHEO. America's policymakers seem to believe that any change has to be modest—there are debates about funding for OFHEO, or the creation of another regulator. In fact, the time for special treatment is over. Congress should begin the task of abolishing Fannie Mae's and Freddie Mac's privileges altogether. The aim should be to turn Fannie and Freddie into normal private-sector financial firms, stripped of even an implicit government guarantee. Doing this will not be easy. Nationalising both and then winding down their portfolios might work, though this looks politically unlikely given the billions needed to buy out shareholders. Some kind of break-up of both institutions into many smaller, less powerful entities may be more feasible. And yet despite the difficulties, dismantling Fannie and Freddie in some way has become urgent, and should be tackled forthwith.

Finally, the investigation of wrongdoing at Fannie should not end with the current agreement. The

Securities and Exchange Commission is apparently looking into the accounting mess. The Department of Justice has launched a criminal investigation. If managers truly manipulated accounts to line their own pockets, then surely this is fraud on a criminal scale, and deserves prosecution. Fannie Mae's bosses are not responsible only to their shareholders; the managers of a firm backed by the public have obligations to taxpayers as well. If Fannie or Freddie collapsed, shareholders' losses would be limited to their investment; but taxpayers would be on the hook for the much bigger losses sure to follow.

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Australia

John Howard reconsidered

Sep 30th 2004
From The Economist print edition

Australia votes on October 9th. There is no compelling reason for a change

Reuters

Get article background

THREE years ago, when Australia last went to the polls, we said it was time for a change. We applauded the achievements of John Howard, during two three-year terms as prime minister, in maintaining an open and competitive economy and reforming the tax code. But we worried about signs that his reformist zeal had withered. More damningly, we deplored his willingness to pander to Australia's xenophobes by pushing back over-loaded refugee ships from its shores and forcing them to deposit their human cargo on the bleak shores of Nauru and Papua New Guinea.

Australia's voters took a different view, awarding Mr Howard a third term and a slightly increased majority. Now he is seeking a fourth, a feat previously accomplished only by Bob Hawke and Sir Robert Menzies. The polls show a result too close to call (see article). Considering the huge domestic unpopularity of the war in Iraq, in which Australia has been a valuable participant, that is no mean achievement for Mr Howard. And we must note that, in the run-up to this vote, there has been no crass attempt to steal the headlines by harsh treatment of refugees or other vulnerable people.

The reasons Mr Howard looks a better bet than he did last time are only in part a function of the prime minister's qualities. They have at least as much to do with the uncertainties surrounding his charismatic Labor challenger. Mark Latham has the virtues of youth (he is a mere 43, to Mr Howard's 65) and vigour. He is famous for once having broken the arm of a taxi-driver in an altercation, and his fondness for colourful language is refreshing. But the flip-side of youth is inexperience: Mr Latham has been party leader for only ten months, and in Parliament for ten years; and he has never held federal office. His tendency to make policy on the fly exasperates his associates and delights his opponents. It was in just such an unguarded moment that he committed a future Labor government to bring Australia's troops home from Iraq.

Iraq convulsed Australia. A clear majority of its citizens believe the war to have been wrong, and demonstrations against it were the largest in the country's history. But Mr Latham's suggestion has not benefited him much. Mr Howard has been able to depict it as “cutting and running”—which is exactly what it is. By pulling out in the face of terror, the governments of Spain and the Philippines have already sent a terrible message to those who cut off the heads of their victims and post their atrocious videos on the internet. Mr Howard's determination to support the effort in post-war Iraq, even in its darkest moments, is one reason to think the better of him.

The other is the economy, which has continued to defy all expectations. It is now in its 13th consecutive year of growth—and growth in excess of 3% a year at that. Despite a government tendency to indulge in vote-winning give-aways, the budget is still in surplus. Mr Howard is guilty of making rash tax concessions that have encouraged the purchase of property for investment. This has inflated a property-price bubble. But the bubble has yet to burst, and in the meantime Labor has made some disturbing noises about its own economic plans. In particular, Mr Latham has raised serious concerns about how he would handle Australia's unions. Labor has promised to restore centralised collective bargaining, scrapping the system of individual workplace agreements that were introduced by Mr Howard and have helped to raise productivity. This time round, the case for change is distinctly uncompelling.

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The EU and China

Don't lift the arms ban

Sep 30th 2004
From The Economist print edition

China needs to prove itself a worthy friend

Get article background

AP

ONCE a rebel and proud of it, these days China counts itself among the world's great powers and craves the respect it feels such status should bring. The European Union, equally keen to be accepted as an emerging power to be reckoned with, sees China as a potential “strategic partner”. Before too long, on current trends, each may well become the other's largest trading partner. As China takes on more of a role in world affairs, from trade and finance to diplomacy and peacekeeping, the two have much business to do. But for China there is a stain on this new-found friendship that it wants removed: the EU's 15-year-old ban on arms sales to China.

At high-level meetings with Europeans, such as next week's ASEM (Asia-Europe Meeting) summit in Vietnam, and the annual EU-China summit later in the year, it will lobby strenuously, over equally strenuous objections coming from America, for the embargo finally to be lifted. And 15 years on, why not? The trouble is that, by setting aside the ban to please its new friend, Europe could end up shooting itself in the foot.

Dropping the ban enjoys some support in Europe. Imposed after the 1989 massacre in Beijing's Tiananmen Square, it is now an anachronism, argues France. Germany, Spain and Italy, among others, would probably agree. The world has moved on; today's China is a modern, more stable place. Why bracket it with Myanmar, Sudan and Zimbabwe, three other miscreant regimes singled out for similar opprobrium? Anyway, lifting the ban on China would be little more than a symbolic gesture since, unlike the Russians, the Europeans won't be lining up to sell state-of-the-art fighter aircraft, bombers, submarines and warships—the EU's code of conduct on arms sales will see to that.

Yet keeping the ban would be a symbol of a different kind. Although much time has indeed passed since Tiananmen, some who survived the bloodshed to be locked up in 1989 are still behind bars. China's poor human-rights record has improved a bit, yet people are still put in jail for their political or religious beliefs, and the government has yet to ratify the UN's Covenant on Civil and Political Rights. None of this has stopped China joining the WTO, or prevents it trading with all and sundry, including America. But that makes the symbolism of the EU's arms ban, like America's, that much more important: a reminder that the outside world still cares.

China's choice

Keeping the ban, which covers defence technology as well as weapons, has strategic as well as political value. China's arms build-up in recent years has been aimed chiefly at intimidating Taiwan, which it claims is a renegade province that it will eventually recover, by force if need be. Some Europeans think this is no concern of theirs; anyway it is America, not Europe, that is pledged to help Taiwan should China's threats turn into aggression. But that is dangerously short-sighted. Europe's considerable interests in Asia would suffer badly in the event of any dust-up between the region's largest and fourth-largest economies. And if America were then to find itself facing off over Taiwan with a China equipped in part by its own NATO allies, the transatlantic alliance itself could become another among the casualties.

Might the EU's code of conduct help guard against such a self-defeating outcome? It calls for licences to be denied where equipment might be used to abuse human rights, press territorial claims by force, or harm the interests of friends or allies. But the code is not binding; governments can interpret it as they see fit, and some are clearly keen to start selling again. EU experts have been working on ways to tighten the code, making it easier to find out who proposes to sell what—and not just to China. But no one doubts that, with the ban lifted, more militarily useful things would get through. China would be just as pleased with western communications, radar and other technologies as with more obviously offensive weapons.

This does not mean that the ban can never be lifted. But Europeans should first expect a sustained improvement in China's human-rights record and, above all, a recognition that, whatever its differences with Taiwan, these must be settled peacefully. Instead of wringing its hands over whether to lift its ban, the EU should be pointing out to China that there are limits to friendship that only China itself can remove.

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About sponsorship

Palestine and Israel

Break that bloody stalemate

Sep 30th 2004
From The Economist print edition

Elections among Palestinians can help, even if they re-crown Yasser Arafat as leader

AP

LOVE him or hate him, Yasser Arafat is one of the great survivors of all time. Frail and doddery for his 75 years, suffering from Parkinson's and other diseases, holed up in humiliation in a bombed-out office block in Palestine's benighted West Bank for the past three-and-half years, occasionally threatened by Israel's leaders with expulsion and even assassination, he is widely considered, in the end, a flop. He has dismally failed to build a proper democracy on his own patch, allowing corruption and gross patronage to flourish around him. More important for the Palestinians, he has failed, whatever the reasons, to bring them their independent state on the West Bank and in Gaza, the territories occupied by Israel since the war of 1967.

Most importantly for Israelis, he has also failed, as the Palestinians' elected president, to stop a variety of armed factions operating in the name of Palestine from launching raids, including suicide-bombings that have killed hundreds of civilians. That is why, say the Israelis, the “road map” laid out by American and European draftsman has had to be furled up. As a result, both the United States and the Israeli governments have declared Mr Arafat a non-person with whom negotiation can never be worth restarting. If the Palestinians want a settlement, they must find someone else to arrange it.

This conclusion, though understandable, is, for a variety of reasons, mistaken. For one thing, despite his manifest weaknesses, Mr Arafat is still the undisputed and elected leader of the Palestinians, and shows no sign of quitting (see article). It is to be hoped that in the next few months Israel will allow a string of elections, at all levels, in the Palestinian territories. With luck, this should produce a more responsive, accountable, youthful and energetic set of representatives. It would be delightful if a fresh and dynamic new Palestinian leader were to emerge. It may happen sooner rather than later. Mr Arafat should have bowed out voluntarily. Would-be successors are waiting in the wings. But they cannot come forward, with the necessary popular backing, until the old man has gone. It is almost certain he will be re-elected—by a massive majority. Like it or not, he still has the power to block any deal presented without his approval.

Is he incorrigible?

It may be argued that the fact of Mr Arafat's election as the Palestinians' leader is not a sufficient qualification to re-engage him as an interlocutor. If, as the Israelis say, he has consistently broken reams of solemn undertakings, leading, among other things, to the deaths of thousands of people, why should he be trusted to start negotiating again? If only recent history were that simple. In the chicken-and egg arguments over apportioning blame for the failure of past negotiations, Mr Arafat has been by no means wholly at fault. He fumbled at Camp David in 2000; at Taba in 2001, when the two sides came close to a more generous deal, he should have pinned the agreement down. He is an inveterate prevaricator.

In any event, if Mr Arafat wants to be let back into the debating chamber, he must prove his credentials anew. Once a new slew of Palestinians are elected, he and they need to reassert control over the plethora of violent groups waging war in the name of Palestine—and enforce a ceasefire. It will be hardest for him to persuade Hamas, the Islamist group responsible for most of the suicide-bombings, to desist. And he must restate his acceptance of Israel as a Jewish state and his belief in two states living side-by-side in peace and security.

If so, Mr Sharon should then reciprocate, for a start letting Mr Arafat move freely among his people. The Israeli leader, though not his Likud party, has accepted the two-state notion, but the chances of his offering more than what his predecessor suggested at Camp David, let alone at Taba, are minimal. His hope, many believe, is that the security fence and other harsh measures will put the Palestinians into a shrinking box and squeeze the fighting spirit out of them. But that will not work. His barrier will not, in the long run, make Israel safe—or provide a minimally contented state for the Palestinians.

As usual, it is for the Americans, with Europeans more involved than before, to knock heads together. George Bush has gone far to accommodate Mr Sharon; John Kerry has carefully sounded no less amenable. While hoping, as sensible people must, that a better leader will emerge, they must also again accommodate Mr Arafat, so long as he is the Palestinians' elected leader—and once he shows he can eschew violence.

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British politics

Tony Blair's secret weapon

Sep 30th 2004
From The Economist print edition

How the Tories are helping keep Labour afloat, and how they could help to sink it

Getty Images

Get article background

THE prime minister is normally good at talking his way out of trouble, but even he couldn't do it this week. Tony Blair's speech to the Labour Party conference was carefully judged—placatory rather than tub-thumping—but it will have done little to help him out of the hole he is in. After years of political levitation, Mr Blair has fallen so far that a large majority of voters are dissatisfied with his performance.

The conference encapsulated Mr Blair's problem. He had hoped to use it as a springboard for the election expected next May, but events—in particular the kidnapping of Ken Bigley, a British hostage in Iraq—dragged him back to the subject he would have preferred to avoid. Since he could not put Iraq behind him, he dealt with it as best he could—admitting that the intelligence had been wrong while insisting that the war was right. But there is no good way for him to deal with Iraq.

It isn't so much that Britons feel for the suffering of the Iraqi people. Once Iraqis took over the government, the country disappeared overnight from British newspapers' front pages. These days, it takes a British hostage or several dozen dead Iraqis to bring it back to prominence. But the impact on Mr Blair's image has gone deeper. Some people believe he lied to them. Some think he just got it wrong. But whether his sin is dishonesty or incompetence does not much matter: his judgment has been shown to be faulty, and judgment is a prime minister's most important quality.

Nor is Iraq the only thing that voters are grumpy about. Taxes have gone up, and are widely expected to go up further after the next election. Although the huge increase in spending on public services—in particular health—is beginning to improve services, fairly few people seem to have noticed that things have got better. What's more, voters now seem to take the government's remarkable record of economic growth and stability for granted. Although Labour is the party most trusted to run the economy, nearly two-thirds of voters say that they have not prospered under this government.

Yet despite his deep difficulties over foreign policy and his government's mixed record at home, the betting is still on Mr Blair to win the next election. That's less because of what he's got right, than because of what the opposition's got wrong.

Third parties don't count in the British electoral system. Hence, although the boost the Liberal Democrats have enjoyed as a result of their opposition to the war may change the electoral arithmetic, it won't win them power. Only the Tories can pose a serious challenge to Labour. Since they lost power in 1997, they haven't really threatened to.

The Tories' temptation

One reason for the Tories' failure, as a YouGov poll for *The Economist* (see article) shows, is that they keep choosing the wrong leader. After they binned first William Hague, who lost them the last election, then Iain Duncan Smith, who failed to make any impact as his successor, they went for Michael Howard. This seems to have been an error. As a former member of John Major's cabinet, Mr Howard reminds voters of a period of Tory government which is best forgotten. And, more seriously, he has relied on

opportunist thrusts at the government instead of defining a long-term strategy to deal with Labour's successful occupation of the centre ground.

So how should the Tories be trying to define themselves? The temptation is to follow the polls to the social right and the fiscal left: throw out the foreigners, leave Europe and keep taxes high. Yet that is just what they tried last time around, and it didn't work. A hard-right, big-state Conservative Party is more attractive as an idea than a reality.

What the Tories have not done since the days of Margaret Thatcher is to promise tax cuts—yet that is one of the main things Conservatism used to be about. Today's Tories are scared to, because a majority (though not a huge one) of voters say they want better public services, not lower taxes.

These fears may be ill-founded, for two reasons. First, voters don't always know what they want until politicians tell them. That's called leadership. Second, things are changing. Taxes have gone up and will go up more. Sooner or later, voters will want lower taxes; and the Tories would do well to lead them to that point, not follow them.

There's not much chance of the Tories turning into a credible opposition before the next general election. But if Labour is returned to power next year with its majority and self-confidence much reduced, it will be time for a new Conservative leader to rediscover some old ideas.

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Letters

Sep 30th 2004
From The Economist print edition

The Economist, 25 St James's Street, London SW1A 1HG
FAX: 020 7839 2968 E-MAIL: letters@economist.com

Turn Turkey away

SIR – Those who favour Turkish membership of the EU usually put forward two arguments ("Why Europe must say yes to Turkey", September 18th). They are that it is too late to say no and that admission will encourage Turks to embrace liberal democracy—your key recommendation. Both arguments are weak. Although Turkey has gained candidate status it is not too late to admit that we are wrong. The other argument rests on two disconcerting assumptions. The first is that liberal democracy is so weak in Turkey that a mere "no" from Europe would suffice to throw the country into the embrace of hardline Islamists. The second is that membership of the EU will suffice to induce a transformation of Turkey to a modern, truly democratic and liberal society. Democracy comes from within; it cannot be imposed from outside—look at Baghdad.

Why should Europe shoulder the risks of Turkish membership? The rewards of making a nice gesture to the Muslims, which could bring some stability to the Middle East, are uncertain and scant. The costs are certain. Turkey is huge and poor and will absorb a disproportionate share of EU funds. Given that Europeans are sceptical about Turkey, why proceed?

Marco Fantini
Brussels

Freedom for democracy

SIR – One finds typical entrenched European thinking about democracy in the statement, "you still have to run it properly" ("No way to run a democracy", September 18th). Who would *The Economist* have control American democracy in order to run it properly? There is a reason why America is the world's most vigorous democracy—our culture has and always will resist entrenched control by any individual or group. The "ills" you point to are nothing more than the expression of the checks and balances that continuously evolve from the American conscience.

Stephen Brahm
Hemet, California

SIR – Why does barely half the eligible electorate bother to vote in America? Why does anyone vote at all? It is inconceivable that my vote for president will affect the outcome in my home state of Virginia. Likewise, it is as unlikely that everyone else will behave rationally and choose not to vote, rendering my ballot substantial. If I submit my absentee ballot in the election, I will do so for no reason beyond conviction and enjoyment.

William Pegues
Ottawa

SIR – You fail to mention one of the most glaring democratic deficits in the United States. The 600,000 residents of Washington, DC, have no representation in the Senate and only a non-voting delegate in the House of Representatives. Yet, unlike residents of Puerto Rico, the US Virgin Islands and other territories who are similarly placed, we pay a full share of federal taxes and suffer the highest level of state tax in the country. Democracy? Humbug.

Patrick Macrory
Washington, DC

Retired hurt

SIR – Without wishing to diminish our present Labour government's largely successful attempts to wreck British pension schemes, credit must also be given to a previous Conservative administration ("How Labour wrecked your pension", September 18th). Margaret Thatcher's government was directly responsible for the pension mis-selling scandal and with it the weakening of the influence of company schemes. Her chancellor, Nigel Lawson, required companies and pension-scheme trustees to eliminate excess surpluses from their funds. The result of this raid was that firms were prevented from building up surpluses in good times but encouraged to take contributions holidays instead (or increase benefits extravagantly). When bad times came more members suffered losses of benefits than would otherwise have been the case.

The unholy combination of political point scoring and blinkered Treasury greed may be good for actuaries and pensions lawyers, but give a thought to pensioners.

Roderick Ramage
Coppenhall, Staffordshire

Legacy of empire

SIR – The British legacy of appointed government in Hong Kong is to blame for the lack of democracy in the former British colony ("Suffrage on sufferance", September 18th). Over 156 years of rule, the British government failed to see the need for democracy. Only during the negotiation to turn over the colony to China was the question of democracy brought up in earnest and enshrined in the Basic Law.

Had democracy been well established in Hong Kong when it was turned over to China, it would hardly have been conceivable that it could be undone. It is the British government that has handed Beijing the excuse to drag their feet on the issue of democracy in Hong Kong.

Andrew Chan
Toronto

Out of harm's way

SIR – You suggest that Britain's new Mental Health Bill, if made law, will allow ministers to evade public blame for murders by the mentally ill ("Psycho politics", September 11th). Speaking as a psychiatrist, I am alarmed. Debate tends to presume that psychiatrists can reliably predict which people will commit violent crimes, and then focuses on the ethics of whether these people should be detained. I can no more accurately predict who will commit murder than I can the lottery numbers. I can guess, based on knowledge of past behaviour and current illness, but no more than this. No psychiatrist can do more. Therefore, fearful of shouldering the blame for murders committed by patients, we will be under pressure to detain ever more of them, in case they commit murder in the future. The public (of whom at least a third will suffer some sort of mental distress in their life) should be very afraid.

Dr Emma Crampin
London

Man v machine

SIR – You state that companies may put customers off by installing impenetrable voice-mail systems that are designed deliberately to prevent connection with a real person ("Do it yourself", September 18th). You also say that menus cannot cover every eventuality. How true. Anyone who has called the consulate of any country to inquire about a passport, entry regulations, visas, etc, will confirm this. The most enthusiastic adopters of voice-mail are those least interested in the opinions of their customers. At the top of the list are governments.

Ricardo Cabeza
Hong Kong

SIR – Self-service goes back before 1916 and Clarence Saunders's Memphis Piggly Wiggly supermarket ("You're hired", September 18th). Between 1869 and 1872, the Bon Marché department store in Paris made two ground-breaking innovations: it displayed its wares for customers to inspect (ie, self-service) and introduced price tags (so no longer was the price determined by haggling). The vending machine, introduced in the late 1800s, also pre-dates Piggly Wiggly.

Jon Manning
Melbourne, Australia

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Palestine

A bloody vacuum

Sep 30th 2004 | GAZA, NABLUS AND RAMALLAH
From The Economist print edition

AP

Stalemate between Palestinians and Israelis looks total, but internal rows on both sides offer a shred of hope

THE plight of the Palestinians is dire—and worsening. Hatred between the two people, Palestinian Arabs (most of them Muslim) and Israeli Jews, some 10m of them jammed in a little slice of holy land between the River Jordan and the Mediterranean, has rarely if ever been deeper. A large portion of Israelis, and certainly most of those who vote for the current Likud-led government of Ariel Sharon, think the Palestinians and their leader, Yasser Arafat, still want to throw them into the sea. Anti-Semitism, they think, is ingrained in the Arab psyche. Most Palestinians gravely doubt whether the Israelis are willing to grant them a viable, contiguous, sovereign state. Many think that Mr Sharon, and those who support him, consider them sub-human.

Since the breakdown of talks at Camp David in the summer of 2000, the Palestinian uprising, the *intifada*, in which 3,300-plus Palestinians and 1,000-plus Israelis have perished, has entered its fifth year. Despite some signs of it abating, there is not a flicker of hope, in the short run, that even a truce is in the offing.

Visit the town of Rafah, at the southern tip of the Gaza strip, and you see why. Earlier this summer, after Palestinian fighters had killed 13 Israeli soldiers, the Israeli army struck back, killing some 43 Palestinians, many of them civilians, demolishing some 277 buildings in the course of three weeks, and, according to the United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA), rendering nearly 3,500 Palestinians homeless. Since the *intifada* began, nearly 15,000 people in Rafah have lost their shelter.

In the past fortnight, the Israeli army, in pursuit of fighters, has flattened another 35 houses. Many of the displaced live in tents; inevitably, many young men have become fighters, even suicide-bombers. Across the Palestinian territories, the Israeli security forces continue to demolish the houses of suspected as well as proven fighters; more than 612 houses have been blown up or bulldozed since the *intifada* began, according to Btselem, an Israeli human-rights group.

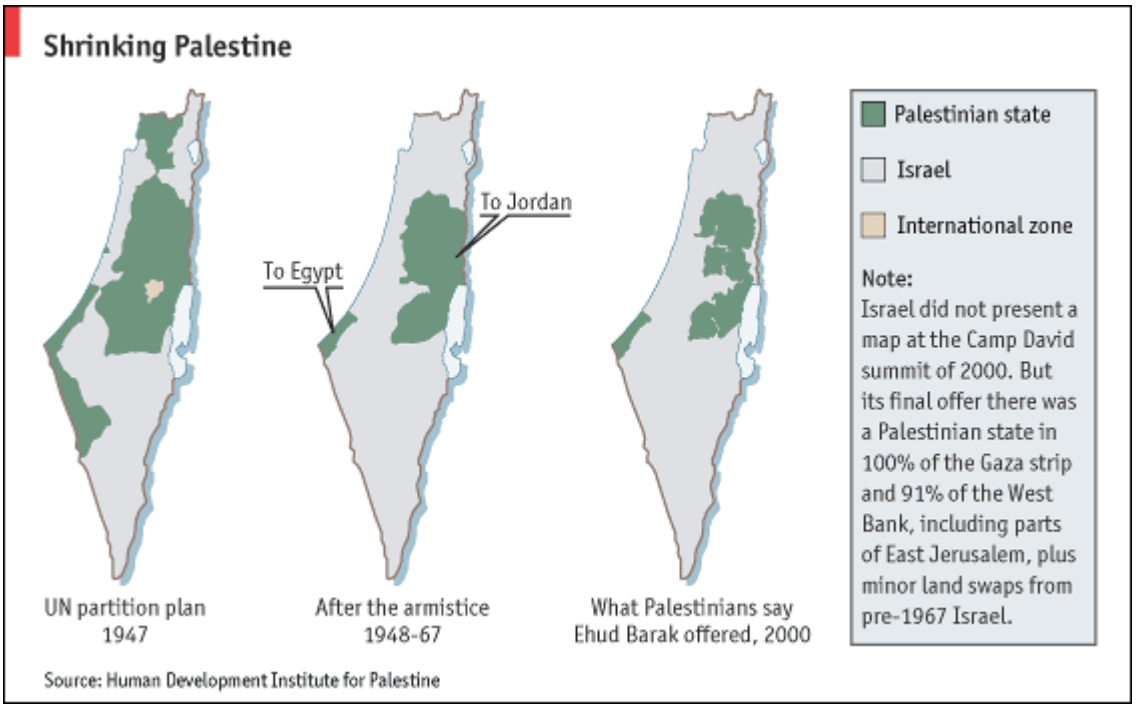
The nearer you get to Gaza's border with Egypt, where Palestinians have habitually dug tunnels for smuggling arms, the more the town looks like a moonscape of desolation. Nationalist graffiti, the ubiquitous posters of “martyrs” and the occasional green flag of the Islamic Resistance Movement, better known as Hamas, hoisted on shell-holed houses offer scant relief. Local youths warn you to keep away; Israeli snipers by the border, they say, shoot first and ask questions later.

The *intifada*, and Israel's fierce reaction to it after March 2002, when its forces retook most of the West Bank towns that had been run, under the Oslo agreement, by the Palestinian Authority (PA), a fledgling government under Mr Arafat's presidency, have made Gazans even poorer than they were already. Of the 1.4m Palestinian population squashed into the 45km (28 mile)-long strip, 922,674 are registered as refugees whose families fled or were expelled at the founding of Israel in 1948 or after the Jewish state's conquests in 1967. Many thousands still live in makeshift concrete-block dwellings with no sewerage.

The average daily wage for Palestinians in Gaza, at the end of last year, was $12 a day. Before the *intifada*, 30,000 Gazans crossed into Israel proper every day to get work. Now a few thousand do. Some economists put unemployment in the strip at 60%. Those in work look after an average of 7.7 dependants.

Israel now controls 42% of Gaza's land, for military purposes or for the use of 7,000-8,000 Jewish settlers. These have a quarter of the strip's arable land, control nearly all the wells, and require some 6,000 Israeli soldiers to protect them—hence, in part, Mr Sharon's desire to withdraw from the strip next year.

Gazans are pretty well sealed off not just from Israel but also from the West Bank, the bigger bit of a future Palestine; permission for Palestinians to travel between the two is not easily granted. Gaza's seaport and airport have been destroyed by the Israelis. Within the strip, checkpoints constrain movement; some roads are reserved for Israeli soldiers and settlers only. Gazans habitually describe their bit of Palestine as a cage or prison.



This grim situation has prevailed since mid-2002. But it has got worse in the past year or so because of the near-collapse of the PA and the consequent growing lawlessness among Palestinians. The police, who come under the PA, barely function. Criminal gangs often merge with proclaimed anti-Israeli fighters. The PA and its leadership around Mr Arafat are widely reviled as corrupt, as well as divided and weak. Hence, especially in Gaza, the rise of Hamas, which is viewed by many as honest, disciplined and brave. If Mr Sharon manages to bludgeon his plan for Israel's withdrawal from Gaza through his parliament and party, no one is sure which Palestinian group would run Gaza.

No better on the Bank

The mood of gloom among the 1.8m Palestinians in the West Bank itself is no less pervasive. But the Palestinian sense of being choked off into ever-diminishing patches of relative autonomy is becoming steadily stronger. The 160-odd checkpoints punctuating all the roads and encircling all the main towns often take an hour or more to pass through.

This feeling of being bottled up has been enhanced by the Israelis' security barrier. This cuts through the

western side of the West Bank and is poised to loop round the five largest Jewish settlement blocks there, including three surrounding Jerusalem. Its length, when it is finished in a year or so, is estimated at between 630km and 724km; so far, more than one-third of it has been built, mostly in the north. About a tenth of it, so far, consists of an eight-metre-high concrete wall which in some places divides Palestinian communities, bars children from their former schools and cuts off farmers from their land, which continues to be confiscated for security and settlement-expansion.

The Palestinians say that some 340,000 of them will be caught on the "wrong side" of the fence; that is to say, they will be stuck between the "green line" that marked the border between Israel proper and the West Bank until 1967, and a new line, farther east, laid down by the fence. Many Israelis, particularly those in Likud, frankly say that such Palestinians should move to join their cousins on the newly demarcated Palestinian side. Virtually all Palestinians see the barrier as part of an Israeli plan to grab more land and to make their fledgling state, criss-crossed by roads reserved for use only by Israelis, nothing more than a collection of "bantustans" or ghettoes, fenced off by an "apartheid wall".

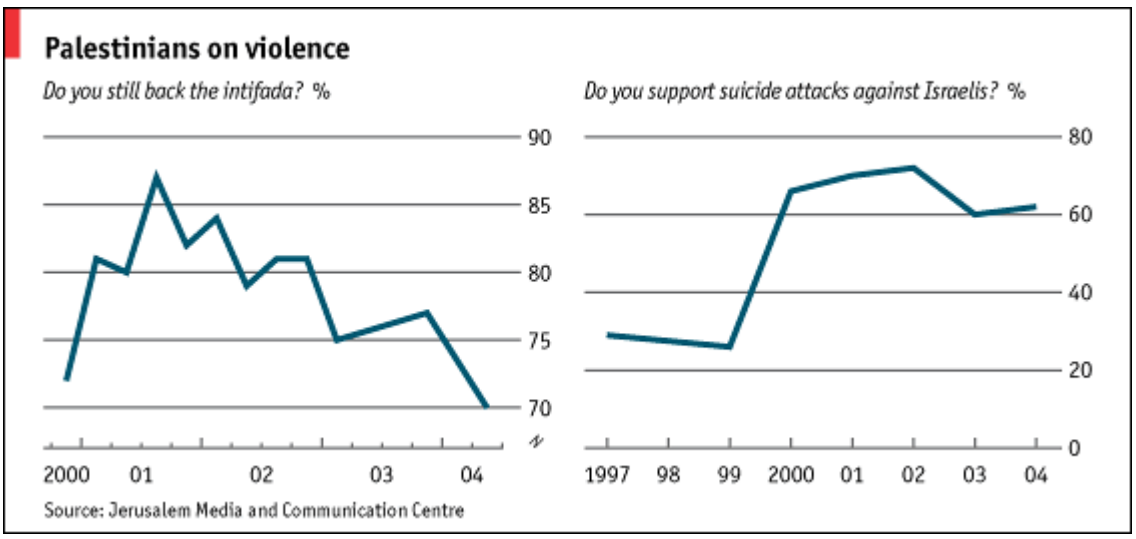
The breakdown of law and order, in the West Bank as well as Gaza, is increasingly plain. Take Nablus, the should-be commercial capital of the coming state. In the past few months the mayor, Ghassan Shakah, has resigned in despair after the murder of his brother. The police seem incapable of tackling crime and violence, separate from rumbling *intifada*. Many prisons have been destroyed. The writ of the PA, except as an agent for paying some 140,000 civil servants, barely runs.

Palestinian guerrilla groups have fractured. The al-Aqsa Martyrs Brigade, affiliated to Mr Arafat's Fatah group, is not only plainly out of Mr Arafat's control; in Nablus it has itself split into factions that occasionally fight each other in the warren-like casbah of the old city. Further north, in Jenin, the Palestinian movement is rent by the same violent factionalism.

Israeli forces regularly make incursions into such disaffected towns to pick off ringleaders, sometimes with uncanny accuracy but often killing bystanders and children. Hundreds of Palestinians have been killed in this way. Mistrust among Palestinians is sharpened by the presence of hundreds of full-time agents for the Israelis and probably thousands more occasional informants and collaborators, whom the PA's own security services have sometimes tortured and murdered.

The Israelis express sorrow for the misery of ordinary Palestinians—but put the blame squarely on the terrorists whom they succour and on their leaders, Mr Arafat to the fore, for egging them on. Moreover, Palestinians consistently express support even for suicide-bombers. "They bleed us, we must bleed them," is the standard justification. Since the *intifada* began, some 16 Israeli children aged 13 and under have been killed; the Palestinian figure, according to Btselem, is 183.

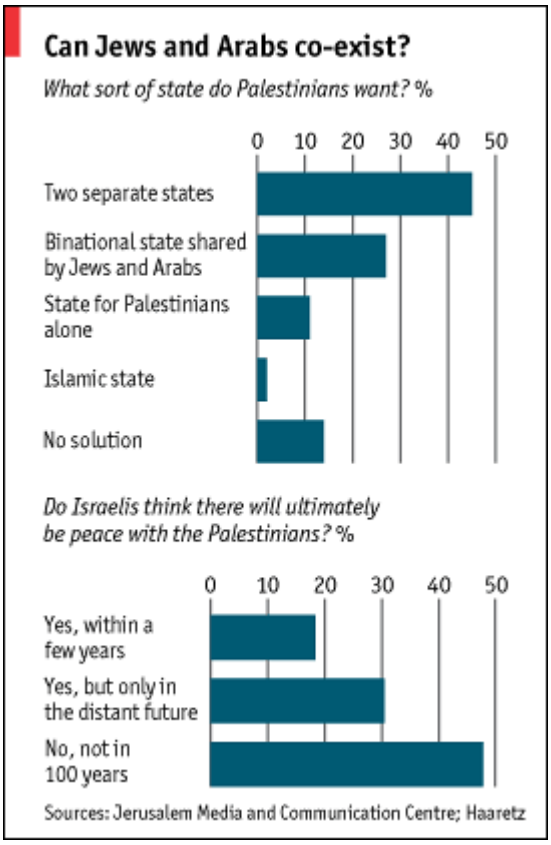
But the increasing physical separation of Palestinians from Israel makes it easier to become inured to their plight. In particular, the barrier seems to be having an effect; since March this year only four suicide-bombers have managed to get into Israel and blow themselves and innocent Israeli citizens up. Last year alone, they perpetrated 23 such horrors. In sum, the wretchedness of Palestinian life, say the Israelis around Mr Sharon, is wholly due to the violence which they continue to direct against Israel and Israelis.



Against this backdrop of unremitting bitterness, reciprocal violence and growing chaos, one glimmer of hope is that the Palestinians may now have a chance to choose a new leadership—at all levels. Between now and March, the plan is for elections to take place for local councils, for the national legislature, for the presidency and—perhaps most important of all—within Fatah, the group that has always dominated the Palestine Liberation Organisation under the leadership of Mr Arafat.

The frail old man

One of many reasons for the dismal performance of the PA under Mr Arafat is that for the past three-and-a-half years he has been holed up in a bombed-out compound in Ramallah, forbidden by the Israelis from travelling across his domain and barred from any formal contact with the Israeli government. With American support, he has been declared a non-person, unfit to be an interlocutor in future negotiations for peace.



Ordinary Palestinians are ambivalent about Mr Arafat. He is their symbolic and so far unrivalled leader. Every opinion poll puts him far above his rivals, were there to be an election for president of the PA, which he last won in 1996 with a vote of 88%. He says he welcomes an election.

And yet a growing number also think Mr Arafat has failed—both to build a fledgling democracy in their would-be state, and, plainly, to wring out of the Israelis a minimally fair peace deal. Over 90% of Palestinians, according to opinion polls, think the PA is corrupt, while often blaming “those around the old man”, rather than Mr Arafat himself, for the pervasive odour of nepotism and graft.

Physically cut off from his people, he looks pretty powerless. Even within the past fortnight, Mr Sharon has publicly refused to rule out the possibility of kicking him into exile or even killing him. Many Palestinians wish he would go, yet feel it would be almost sacrilegious to endorse Israel's call for his departure.

His physical and mental faculties are not what they were. At 75, he is frail, and probably has Parkinson's disease. In conversation he tends to dwell on the past, with rambling reminiscences and convoluted self-justifications for past failures of negotiation. His aim, as ever, is survival, collective as well as personal. “They have failed to wipe us out,” he says. “We are not Red Indians.” While Mr Sharon rules in Israel, Mr Arafat offers no pressing plan for breaking the logjam. But he can still block any scheme that is not to his taste.

Nowadays Mr Arafat has rivals, though undeclared, within Fatah; and Fatah has a rival, declared, in the shape of Hamas, for the party leadership of the Palestinians. If the various elections proceed as mooted (no clear timetable so far), the results could alter the shape of Palestinian politics, even if Mr Arafat wins the presidency again.

The first big need is to revamp Fatah. In the past few months, a rival for the crown has stepped forward in the person of Muhammad Dahlan, a tough and articulate 43-year-old who hails from the refugee camps of Gaza and once ran Fatah's security force for Mr Arafat. He has made some headway under the banner of reform, his allies recently winning a clutch of local Fatah elections in the strip. But Palestinians who hope for a democratic alternative deplore his use of “old methods” on the street and by means of crude patronage. Worse for Mr Dahlan, the Israelis have earmarked him as a possible alternative leader. As a presidential contender, he got only about 2% in a recent opinion poll.

The other rival for Mr Arafat's crown is Marwan Bargouthi, who is 47. A leader of the first *intifada* in the late 1980s, he too is tough and shrewd, and is more popular. He is currently in an Israeli prison, serving five life sentences for complicity in the murder of Israelis. But polls rate him well ahead of Mr Dahlan, at between 15% and 20%. If Mr Arafat left the scene, if elections gave a new generation their head, and if Mr Bargouthi were released as part of a new peace process, he might be best placed to persuade the Palestinians to accept a compromise.

AP

The great survivor

The other big conundrum surrounds Hamas. On paper, the movement is committed to Israel's elimination. It is the main perpetrator of suicide-bombs, though the al-Aqsa Martyrs Brigade has probably been responsible for about a third of them. But in times of gloom Hamas always grows; it now matches Fatah in popularity. Even in traditionally secular towns like Nablus, it is now, says the former mayor, himself a Fatah man, the most popular movement.

In the past, when Hamas has sought to undermine the PA, Fatah has physically clobbered it. Now, however, most senior Fatah people think Hamas should—and could—be co-opted into a revamped legislative system. Hamas people say they would take part in the elections. Some also say, more crucially, that they would declare a truce and even accept a temporary two-state solution, perhaps for 50 years, while continuing to argue peacefully for one state in which Jews could live, presumably under Arab Muslim control.

Plainly, if a new Palestinian order is to emerge that can persuade Israelis that they have a partner for negotiation, Hamas must either be smashed—or brought into the political discourse. Despite Israel's continuing policy of killing its leaders, Hamas may now be too popular to ignore. As a secular-minded Arab-Israeli member of parliament put it: “There has to be a unified Palestinian command to stop the suicide-bombing.” That would mean bringing Hamas on board.

An array of conditions would have to be met by all sides before talks could start again. For one thing, it is unclear what Mr Sharon's minimal vision of a Palestinian state might be. But at least if the Palestinians showed that they can make democracy work for themselves, it would be harder for the Israelis to refuse to engage with them. “This would be a revolution in the Arab world,” says Mustafa Barghouthi, a clansman of Marwan who runs the Palestinian National Initiative, a democracy-building outfit. “An Arab leader challenged in free elections.”

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Swing states: our round-up

The great trek

Sep 30th 2004 | WASHINGTON, DC
From The Economist print edition

The battleground states look good for George Bush this year. They may be better for Democrats in future

OVER the next few weeks, and especially after the presidential debates due to begin in Miami on September 30th (after *The Economist* went to press), the American election will cease being a national contest and morph into 50 statewide races—or, more precisely, into a dozen races in those "battleground states" whose votes in the electoral college are not a foregone conclusion.

Over this summer, we have looked at 16 swing states individually (see map). But if you consider them collectively, surprising conclusions emerge. George Bush's greatest political advantage may be the current power of cultural resentment in battleground states. Yet long-term trends are helping John Kerry's party, meaning that the 2004 election may prove one of the last stands for the Republican Party in some places that have formed part of its core constituency.

For the most part, the list of swing states in 2004 is similar to that in 2000: Florida, the rustbelt, the south-west. As Mr Kerry's chances waxed in the summer, new battlegrounds popped up—Arizona, even North Carolina. As his fortunes have waned, others have taken their place—Iowa, even New Jersey (see article).

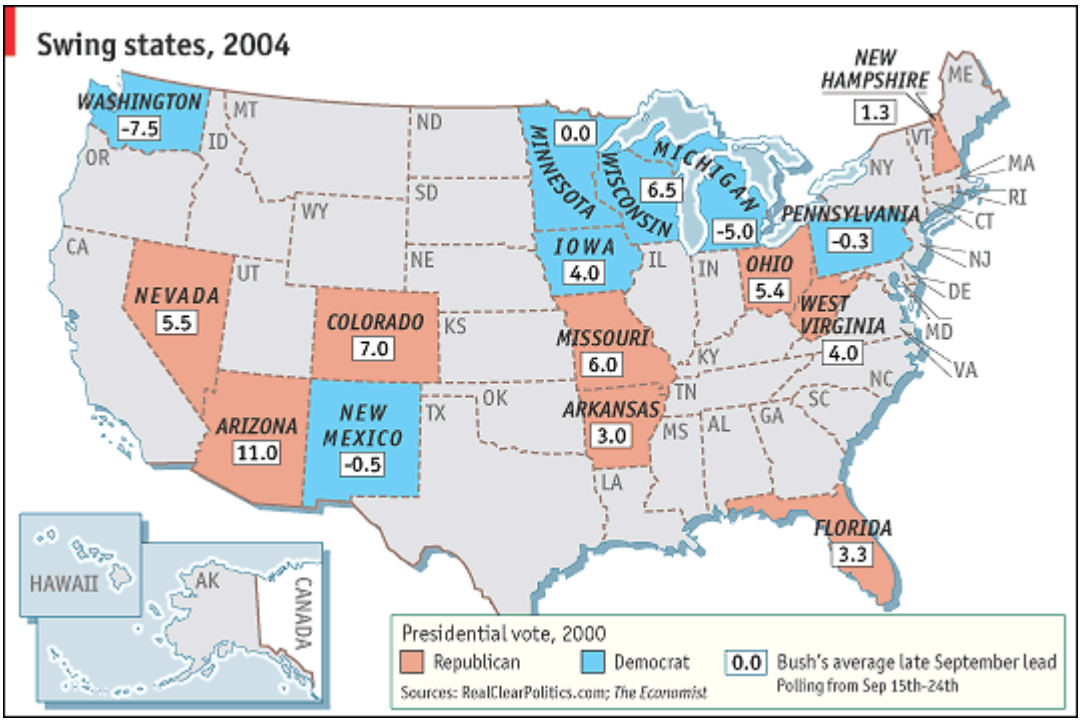
But battleground states form two groups, not one. Bill Frey of the Brookings Institution (using a slightly different list from ours) divides them into six whose population has grown faster than the national average since 1990 and 11 which have been growing more slowly (see chart). The slow-growers have 115 electoral-college votes, compared with 65 for the booming battlegrounds. The slow-growers are all on or east of the Mississippi river; all the fast-growing states except Florida are in the west.

The demographic features of the two groups are dramatically different. Though there are fewer of them, the fast-growers have added 1.9m foreign immigrants since 1995 compared with 1.1m for slow-growing states. In terms of domestic migration, Americans are pouring out of one set of swing states and into another. Ohio, Michigan, Pennsylvania, Iowa and West Virginia have all seen a big outflow of people, but the fast-growing states have attracted more than 2.2m. The contrast between Ohio and Florida is especially sharp. Between 1995 and 2003, Ohio lost 19 people per 1,000 to domestic migration; Florida gained 67. Ohio gained 15 immigrants per 1,000; Florida gained 59.

In demographic terms, the slow-growing swing states look like the solidly "blue" (Democratic) parts of America: both are seeing substantial domestic out-flows offset by even larger international inflows. The fast-growing battlegrounds look more like red (Republican) America: both are seeing international and domestic inflows. That chimes with historical voting patterns: in presidential contests Democrats have tended to carry slow-growing unionised states like Minnesota and Wisconsin, while the Republicans have done better with fast-growers.

So you would think Mr Bush should be doing better among (reddish) fast-growing battlegrounds than in (blueish) slow-growing ones. You would be wrong. First, Mr Bush has been doing well everywhere. He is ahead by an average of two points in all the battleground states, fast and slow, and has improved his position in both by about five points since July.

But second, if you look at the largest, vote-rich states of the mid-west—politically the most important slow-growing region—you will find that Mr Bush is doing particularly well: he has jumped by ten points in Wisconsin, by more than six in Missouri and Pennsylvania, four to five in Ohio and Iowa. In the rustbelt, Michigan is the only state where Mr Kerry is holding on to a solid lead. Why should this be?



The main reason has to do with age and race. If you take out Florida (the nation's retirement home), the slow-growing states are older than the fast-growing ones. In all but three of them, people over 65 account for at least 13% of the population, and, in four cases, considerably more. More important, the slow-growing battleground states are also whiter: 86% of their population is white, compared with 70% for fast-growing states.

As a result, the slow-growing battleground states have disproportionately more white women (45% compared with 36% in the fast-growing battlegrounds); noticeably more ageing baby-boomers (white baby-boomers make up a third of the voting-age population in the slow-growers, compared with only a quarter in the fast) and dramatically more whites with only a high-school education (42%, compared with just 28%).

And who are the most significant swing voters in this election, the people whose shifting support has been the main factor behind Mr Bush's recent rise in popularity? Answer: white women ("security moms"), people with no or a little college education, and non-Latino Catholics. The first two groups are disproportionately represented in slow-growing swing states, and Catholics are strong in the industrial towns of Ohio and Pennsylvania.

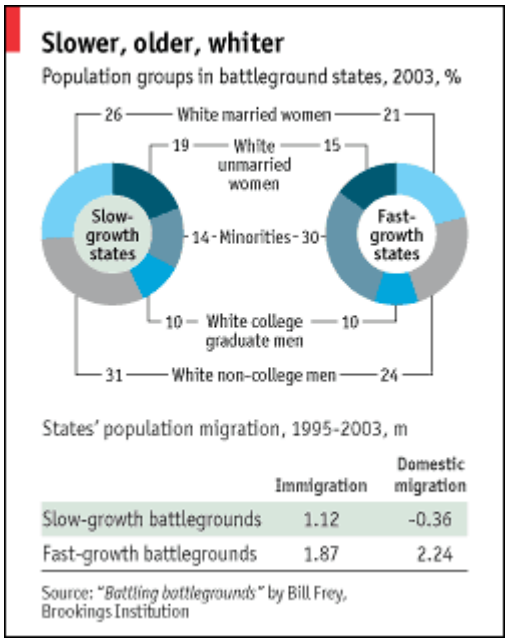
This augurs well for Mr Bush this year, but what about the longer term? Republicans say demography favours them. Taken as a whole, the Bush states in 2000 have gained population and electoral-college votes. But if you look just at the swing states, the situation is almost reversed.

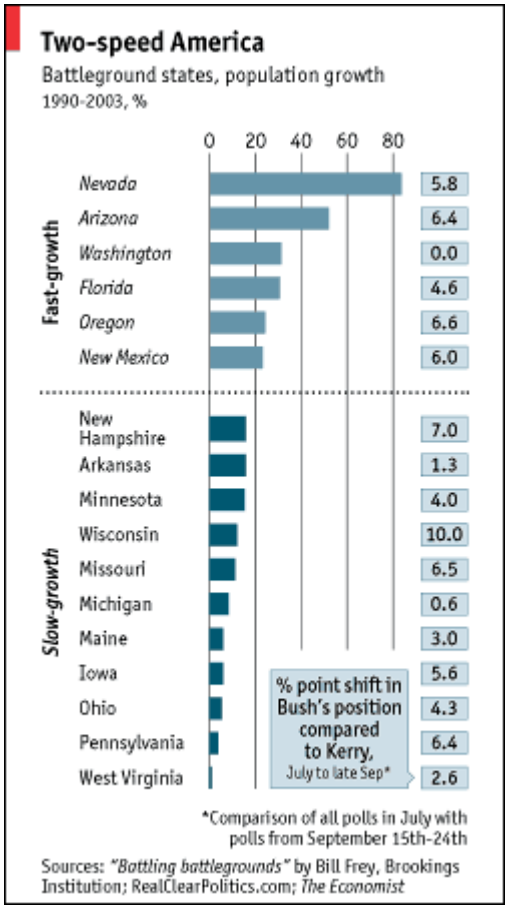
Florida and the western states have been picking up the usual conservative retirees from the rust belt. But they are also attracting more Democratic folk—college graduates from the rustbelt, young families squeezed out of expensive housing markets in California and New York and, of course, Latinos.

This year, these migration patterns seem to be helping Mr Bush. Democrats are not arriving in sufficiently large numbers to tilt Republican strongholds such as Arizona and perhaps Florida (though they have made them more competitive). Meanwhile, their departure has given more prominence in states like Wisconsin to older, whiter, less-well-educated groups for whom the cultural issues of God, family and country matter more than

economic ones. These “left behinds” have warmed to Republican claims to defend “old-fashioned values” from the evils of multiculturalism and secularism.

There is another factor that is probably helping Mr Bush and muting the effect of demography: regionalism. James Carville of the Kerry campaign once described Pennsylvania as Philadelphia at one end, Pittsburgh at the other and Alabama in between. Small they may be, but New Mexico and West Virginia both contain five distinctive regions. Florida has four. Swing states are often battlegrounds because their regions cancel each other out.





Sometimes, migration can tip the balance quickly in small states. West Virginia is becoming more Republican as workers desert the Democratic coalfields in the south. Migration from liberal Boston is also making conservative New Hampshire more competitive. Sometimes, migration just adds more swing voters to regions that are already competitive, as it has in New Mexico. Usually, demographic trends take time to have an effect. In Florida, migration has eroded the importance of both parties' strongholds—the Democratic south-east and Republican south-west—and turned the I-4 corridor into the swing region; but it has not yet changed the character of the state overall.

Regionalism within the states also puts the pressure on a candidate to appeal across a wide range of places. National politics is not just a matter of picking up “security moms”, “office-park dads” and the other national groups of swing voters; a president needs to play well in places as far apart as northern Minnesota's “Iron Range” and Florida's Panhandle.

Mr Bush seems to be better at this than Mr Kerry. He almost always scores higher on likeability tests (“Whom would you most like to have a beer with?”). The intensity of support for him is a few points higher than it is for Mr Kerry. And while Mr Kerry's support is concentrated in big cities, inner suburbs and university towns, Mr Bush's is more evenly spread.

Personal appeal could see Mr Bush through this election. But, eventually, demography must make a difference. The fast-growing battleground states are trending Democratic thanks to those younger voters and Latinos. In 2008, and still more in 2012 (when the electoral college will take account of the 2010 census), the effect could be more marked—especially as more Latinos register to vote and more educated families flee New York and California.

By the end of this decade, the slow-growers in the rustbelt will probably have lost even more graduates to the deep blue and fast-growing battleground states, and even more rich families to the deep red ones. Older whites and poorer families will be left behind. States like Ohio and Pennsylvania will still be important—but perhaps not as important as they will be this year.

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Audio versions are available of 15 of our swing-states reports

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Washington state politics

A Republican double?

Sep 30th 2004 | SEATTLE
From The Economist print edition

Victory might just be possible, if ideology doesn't get in the way

AP

Murray, pro-soccer, anti-war

“TWENTY years in the wilderness is long enough,” says Dino Rossi. So is Mr Rossi, a property broker with an easy manner, destined to be the first Republican governor of Washington since 1980? And will one Republican victory in the liberal Pacific north-west be accompanied by another: the defeat of Patty Murray, the two-term “soccer mom” senator, by George Nethercutt, a local congressman?

Mr Rossi in particular has reason for hope. The current governor, Gary Locke, is voluntarily stepping down after two terms, and his unimpressive approval ratings could tarnish his chosen successor, Christine Gregoire, the state's attorney-general for the past 12 years. So, too, could the dismal factoids for the state that Mr Rossi with practised fluency lays at the Democrats' door: an unemployment rate of 6.2% and more regulations on business than in all but four other states. Although one respected pollster, Stuart Elway, reckons Mrs Gregoire has in the past month turned a four-percentage-point deficit into a five-point lead, other polls give her a lead as narrow as just one point, and plenty of voters have yet to make up their minds.

Moreover, Mr Rossi, with a coalminer grandfather, a schoolmaster father and an alcoholic half-Irish-half-Tlingit mother, has the kind of rags-to-riches story that appeals to the voters: “I've seen the last can of beans in the cupboard more than once.” Add 11 years in the state Senate, where he claims credit for balancing last year's budget, and he is clearly a serious candidate.

Yet the hopeful Mr Rossi should not get carried away. Mrs Gregoire has the name recognition that comes from being the attorney-general who negotiated a $206 billion settlement on behalf of the states with the tobacco industry. True, her office missed a deadline to appeal a court judgment against the state, but Republican jibes that this cost the taxpayer $18m have been largely ignored, thanks to Mrs Gregoire's record on issues dear to Washingtonians, from cleaning up waste from the Hanford nuclear-weapons site in the south of the state to assisting the state's 670,000 veterans. Moreover, as a survivor of breast cancer, she too has a tale to warm the voters' hearts. As for Mr Rossi's claim to reach out to Democrats, she retorts: “He has voted 96% of the time along party lines.”

In the end, what may sink Mr Rossi's bid for power is the millstone of Republican dogma in a state whose instincts are liberal. Mr Rossi tries hard to avoid the abortion issue, but Mrs Gregoire cleverly hints at it by advocating stem-cell research. Similarly, on health care, Mr Rossi, toeing the party line, advocates tort reform and talks optimistically of attracting health insurers back to the state—but by reducing the number of mandates, such as acupuncture, that they must fulfil. By contrast, Mrs Gregoire wants the state to join forces with employers to negotiate discounts from the insurers, and suggests importing cheaper drugs from Canada.

Will Republican dogma sink George Nethercutt, too? He is also something of a moderate by the ultra-conservative standards of the local party. The latest Elway poll puts him 20 points behind Senator Murray, but another (Republican) pollster, Strategic Vision, has him within seven points, with 11% of likely voters undecided. Mr Nethercutt's message is the familiar one of lower taxes and tort reform, allied with an attack on Mrs Murray's liberalism (she has supposedly voted 282 times to increase taxes) and alleged lack of patriotism (she voted against the Iraq war).

Mrs Murray's retort is that Mr Nethercutt is a man not to be trusted: when he entered the House of

Representatives in 1994, he pledged to serve only three terms but went on to serve five. With Mr Nethercutt having moved from his base in Spokane to an apartment near Seattle, Mrs Murray denounces him as “a professional politician who will do anything to get elected”.

Mr Nethercutt certainly knows how to get elected: his victory in 1994 was over Tom Foley, who became the first sitting speaker of the House since 1862 to be defeated in his home district. The same could be said of Mr Rossi, too: re-elected to his state Senate seat in 2000, he won 70% of the vote in a district where George Bush's winning margin was a mere 500 votes.

In the end, it may well be the presidential vote that makes the difference in both races. The polls show John Kerry leading Mr Bush. But if Mr Kerry continues to disappoint Democratic voters, they may not turn up on November 2nd. As Mrs Gregoire ruefully agrees, a lot is riding on the presidential debates.

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The electoral week

On the trail

Sep 30th 2004
From The Economist print edition

Hurricane season

“A repetition of the problems [in Florida] of 2000 now seems likely, even as many other nations are conducting elections that are internationally certified to be transparent, honest and fair.”

Jimmy Carter reports on the election, Washington Post, September 27th

Raising expectations (1)

“[John Kerry] was an all-star debater in prep school and an all-star debater in Ivy League.”

A White House spokesman on the debates, Associated Press, September 27th

Raising expectations (2)

“George Bush is a great debater. He wins them on style not substance.”

Terry McAuliffe, the Democrats' chairman, Associated Press, September 26th

So that's where Rummy's been

A new “Porn for Kerry DVD” will portray the likes of Donald Rumsfeld and Jenna Bush. Profits from the epic (“part political satire and part hardcore hot sex”) will go to help the Kerry campaign.

New York Post, September 29th

Klingons for Kerry

“A good war is based on honour, not deception. The first warrior, President Bush, deceived us all with this war.”

K'tok, ie, Clyde Lewis, an Oregonian Klingon. An in-depth poll of eight warrior-race members purchasing “Trekkies 2” revealed that 75% support Mr Kerry and 25% plan to vote for Satan. Willamette Week Online, September 22nd

The Second Amendment vote (1)

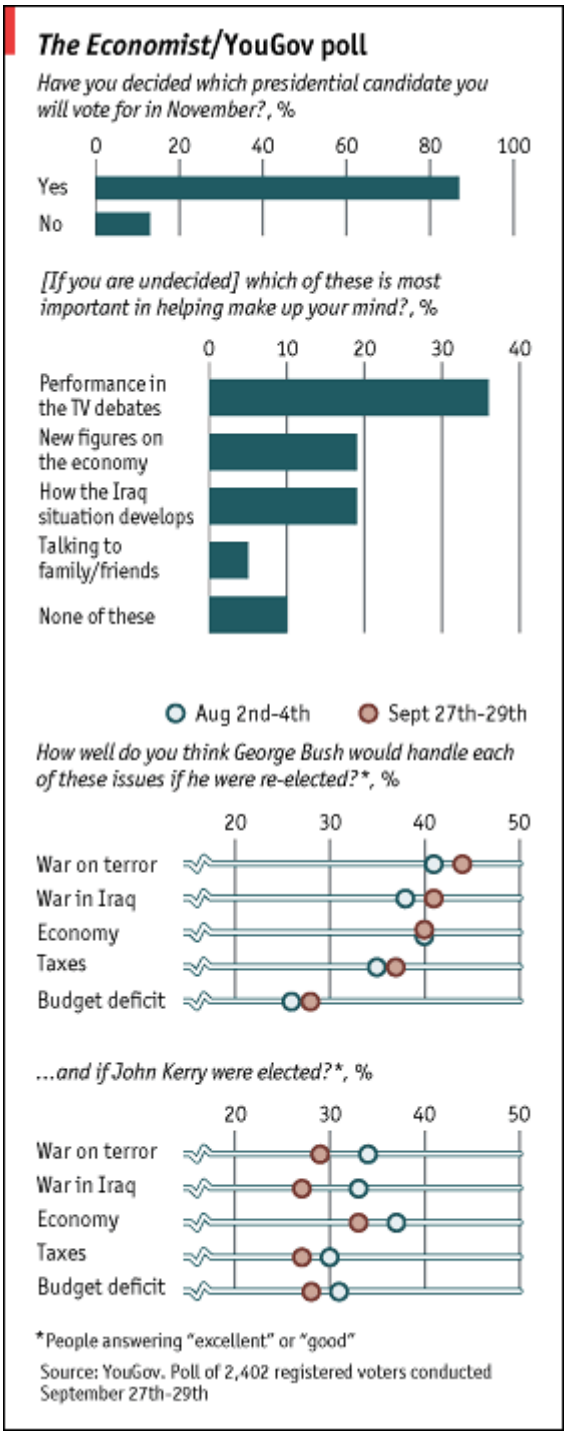
“My greatest day in the field was my last day in the field. This past year, my father and I hunted quail in Beeville, Texas. It was a great opportunity to spend some quality time with my dad and we stirred up several good coveys.”

Mr Bush answers an Outdoor Life magazine questionnaire, October 2004

The Second Amendment vote (2)

“The greatest day I ever had in the field was in South Carolina hunting with my cousins; though last year bagging two pheasants with two shots on my first hunt in Iowa was also a good day.”

Mr Kerry's reply to the same question. Outdoor Life, October 2004



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Sentencing rules

Mopping up after Blakely

Sep 30th 2004
From The Economist print edition

Will the Supreme Court end the sentencing chaos it created?

AFTER three months of growing judicial turmoil, the Supreme Court is due to return next week to its decision on sentencing guidelines in the case of *Blakely v Washington*. In that ruling, issued on June 24th, the court struck down Washington state's sentencing system, deciding, in effect, that juries, rather than judges, should decide the grounds on which a prison sentence can be increased beyond the normal statutory guidelines.

Since then, courts across the country have been issuing wildly different opinions as to whether this affects sentencing systems at all levels. Some judges have been slashing sentences. Others have thrown them out altogether. Sandra Day O'Connor, one of the dissenting justices in the case, has likened the ruling's impact on the judicial system to a “number ten earthquake” on the Richter scale.

To clarify things, the Supreme Court has agreed to hold expedited hearings on October 4th in two federal cases where the sentences of drug dealers were drastically cut in the light of *Blakely*. In one, Freddie Booker had his “enhanced” 30-years-to-life sentence thrown out; under the normal federal guidelines, he would have got 21 years. In the other, Ducan Fanfan was given a five-year sentence instead of an expected 15. The Justice Department appealed, arguing that *Blakely* did not affect federal sentencing guidelines.

Ralph Blakely, a wealthy Washington rancher, was originally sentenced to 53 months in prison, the maximum allowed under the state's guidelines, after pleading guilty to kidnapping his estranged wife at knife-point. But the judge then added a further 37 months to his term on the ground that he had acted with “deliberate cruelty”. Mr Blakely appealed, citing his constitutional right to a jury trial. In a split 5-4 ruling, the Supreme Court agreed that factors involved in determining a tougher sentence must either be admitted by the defendant, or proved “beyond a reasonable doubt” by a jury; they could not simply be determined on the “preponderance of the evidence” by a judge sitting alone.

In an unusual line-up, two conservative justices, Antonin Scalia and Clarence Thomas, sided with two of the court's most liberal members, Ruth Bader Ginsburg and John Paul Stevens, to back the majority ruling. In her note of dissent, Mrs O'Connor, usually regarded as a moderate, complained that the ruling would lead states and the federal government to “either trim or eliminate altogether their sentencing-guideline schemes and, with them, 20 years of sentencing reform”.

State and federal sentencing guidelines have been introduced, over the past two decades, to rule out arbitrary behaviour by judges. Some schemes are more or less voluntary, involving “preferred” sentencing scales. Others, like the federal guidelines, are almost totally mandatory; judges can depart from them only in special cases.

The fate of tens of thousands of prisoners now hangs in the balance. The courts are being buried under an avalanche of re-sentencing petitions and appeals. Some judges have started handing down two sentences, one that complies with the Supreme Court's ruling and a tougher one that does not. Others have put off sentencing altogether until the situation has been clarified. Some are even suggesting that two trials may now be required, one to decide whether the crime has been committed, and another to determine any additional factors that might affect sentencing.

Alarmed by the chaos, Paul Clement, the acting solicitor-general, appealed to the Supreme Court to review its decision—fast. After issuing landmark rulings, the court normally welcomes a certain period of “percolation” in which things can settle down without it having to rule again. But Mr Clement argued that, in this case, “awaiting further percolation in the lower courts is not a luxury that the federal criminal-

justice system can afford."

Some fear that Monday's hearing could spell the end of the whole federal sentencing-guidelines system, in force since 1987. Senator Orrin Hatch has announced that the Senate Judiciary Committee, which he chairs, is working on "a contingency plan to ensure that, regardless of what the Supreme Court decides, we will be able to preserve a system that...reduces sentencing disparity across this country."

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California and climate change

Schwarzenegger v Bush?

Sep 30th 2004 | NEW YORK
From The Economist print edition

A chance for the governor to prove he really is a tree-hugger, after all

Get article background

IS THE Terminator bold enough to take on King George, slayer of Kyoto? That is the chief question hovering round Arnold Schwarzenegger's environmental record. The man who owns a fleet of Hummers has already done some of the easier green things—appointing a few appropriately verdant people to his administration, signing a few tree-cuddling bills and so on. Now the global warming debate offers the chance of a nasty fight with the president.

Mr Schwarzenegger inherited two explosive policies on climate change from Gray Davis, his Democratic predecessor. First, California had joined other states in a lawsuit designed to force the Bush administration to declare that carbon dioxide, the principal greenhouse gas, is a pollutant. That technicality would oblige the federal government to take action to curb CO_2—something that Mr Bush refuses to do. Mr Schwarzenegger has said the state will pursue this lawsuit.

The trickier inheritance involves a state law, passed in 2002, that demands sharp reductions in the emission of greenhouse gases from cars. On September 24th, California's Air Resources Board (ARB), the state's top air-pollution regulator, issued detailed rules for compliance. This is the first such law in the country, and it could have a sweeping impact. California, by itself, is one of the world's biggest car markets; and other economies may well copy its rules, as they have often done with air-quality standards. Seven American states, including New York, as well as Canada, have hinted that they may follow suit.

Even before the ink was dry, lawyers from the car industry and the federal government were ready to pounce. The car industry insists that the technology required to meet the new rules is either unavailable or hugely expensive. Its experts challenge the ARB's assertion that its new rules will cost only about $1,000 per new car in 2016.

The Bush administration, for its part, argues that the state is overstepping its legal authority. Uniquely among American states, California has the right to set its own air-quality standards. But because the production of greenhouse gases by cars is closely linked to the amount of petrol burned, the federal government argues that California's new rules are really fuel-economy standards. Only the federal government has the right to set those.

Is Mr Schwarzenegger ready for a battle royal with both a big industry and his own president? After their early love affair, greens have soured lately on Arnie. A large task-force has just completed a 2,500-page review of all the state government's workings; greens grumble that they were barely consulted, while fat cats—notably from Chevron Texaco, a Californian oil firm—sat at the top table.

It is hard to imagine a Republican governor opposing his president during an election campaign. But once that is out of the way, he may prove the cynics wrong. Despite a frosty reception from some business interests, he has not renounced any of his green campaign pledges. And he has more allies in his party than it first appears.

Other “climate-friendly” Republicans include Governor George Pataki of New York, Governor Mitt Romney of Massachusetts and Senator John McCain. The latter received 43 votes the last time he proposed (against Mr Bush's wishes) a mandatory “cap-and-trade” bill to curb carbon emissions, and he has vowed to pursue this bill as doggedly as he did campaign-finance reform. At present America's climate policy is caught between a hotch-potch of state-led initiatives, Mr Bush's do-nothing approach and some fairly

wild green ideas. In theory, a McCain-Schwarzenegger alliance might be rather useful.

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Thinking about foreigners

Do they love us?

Sep 30th 2004 | CHICAGO
From The Economist print edition

A selfish nation led by altruists

THE image of Americans abroad is often of well-meaning innocents steered by a Machiavellian elite—with the neoconservatives now filling the role that Henry Kissinger used to hog. An impressive new survey of American attitudes to international affairs by the Chicago Council on Foreign Relations shows precisely the opposite.

The American people are much more interested in looking after number one—in protecting their own jobs rather than promoting democracy abroad or fighting world poverty—than their leaders are. Admittedly, the CCFR's definition of leaders includes not just politicians and businessmen, but also people from such well-meaning institutions as churches, universities and, er, the press. Yet there is still a noticeable gap in terms of altruism (see table).

Set beside the last study in 2002, the new research, released on September 28th, shows that the American public are much less concerned about threats from abroad, such as terrorism and nuclear weapons; and they are more reluctant to plough money into homeland security and foreign spying. They still feel strongly that their country should take an active role in international affairs, but 80% say America is policing abroad more than it should; and they would generally prefer to combat terrorism through the United Nations.

As for friends, Americans feel warmest about Britain, then Germany, Mexico and Israel. The unloved are led by North Korea followed by Saudi Arabia, "the Muslim people" and Cuba.

Tough love

The following should be a "very important" goal of US foreign policy, %

	Public	Leaders
Protecting the jobs of US workers	78	41
Preventing the spread of nuclear weapons	73	87
Controlling illegal immigration	59	21
Maintaining superior military power	50	37
Protecting weaker nations against aggressors	18	33
Improving the standard of living in developing nations	18	64
Bringing democratic government to other nations	14	29

Source: Chicago Council on Foreign Relations

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New Jersey

Swinging for Bush?

Sep 30th 2004 | PRINCETON
From The Economist print edition

Shock-horror in the Soprano state

SO SURE of a Kerry victory was New Jersey's Democratic Party that it packed its communications director off to Oregon to do combat there. Millions in donations from the party faithful were sent off to battleground states. The Bush campaign didn't even bother to put anyone on the payroll in New Jersey. They were certain their man would lose.

But suddenly New Jersey may be up for grabs. John Kerry led by 20 points after the Democratic convention, but three recent polls point to a tightening race. A September 21st poll by Quinnipiac University even placed George Bush and Mr Kerry in a dead heat, with 48% support each among likely voters. Ralph Nader had 2%.

If New Jersey swings Republican in November, this would be strange indeed. Al Gore carried it by 16 points in 2000. The governor and both senators are Democrats, and Democrats hold seven of the 13 congressional seats. Moreover, the state's Republicans are a moderate bunch. A new law recognising same-sex domestic partnerships and plans for a huge stem-cell-research centre produced barely a grumble from them. The most recent Republican governor, Christine Todd Whitman, was both pro-choice and an environmentalist.

In some ways, New Jersey is a mere reflection of the national race, where terrorism has trumped the economy as the most important issue. (The state's economy, in any case, is doing well.) The terrorism threat may be more keenly felt here than in any other state (except New York), and this may explain a moderate electorate's sudden craving for Mr Bush.

New Jersey lost nearly 700 citizens in the September 11th terror attacks. The gaping hole along the New York skyline is a constant reminder of the threat. The state attorney-general has just announced a help-line for those still suffering psychologically from the attacks.

The problem for Mr Kerry is that more than half of New Jersey's voters say Mr Bush would do a better job fighting terrorism. The Republican convention in New York, covered in New Jersey as local news, did much to drive home this perception. Mr Bush's Texas swagger and conservative views are anathema to the Wall Street types of North Jersey's leafy suburbs. But their resolve to defeat him withers when they feel their lives—or their livelihoods—may be at stake. In early August, Mr Kerry was ahead by 26 points in North Jersey; that lead has eroded to six points, according to a September 9th *Star-Ledger*/Eagleton-Rutgers poll. Mr Kerry's advantage among voters in the up-and-coming exurbs of central Jersey has also shrunk. The rural, gun-toting communities of north-eastern New Jersey and the blue-collar, socially-conservative counties in the south were safe Bush territory anyway.

The other factor peculiar to New Jersey's race is Governor Jim McGreevey's shocking resignation and disclosure of a gay affair last month. Political scandal, not sex, undid him: he had made his lover the state's head of homeland security. Also, two of the governor's top fundraisers have just pleaded guilty to corruption charges. The upheaval in state politics may be drowning out Mr Kerry's message.

In the end, the Democrats have a good chance of prevailing on election day: it is hard to see dyed-in-the-wool Democrats opting for Mr Bush once alone in the voting booth. The state's strong unions are good at getting out the vote. Shoring up the defences, John Edwards visited New Jersey this week with a local 9/11 widow at his side. But he also touted a plan to import prescription drugs from Canada. This is not quite the drum to beat in the heart of the nation's pharmaceutical industry.

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Lexington

The passion of the Christians

Sep 30th 2004
From The Economist print edition

The religious right could well decide the coming election

THIS November's election is about many things. It is about the future of the West, the war on Islamic terrorism, the beggar-thy-grandchildren deficit, you name it. But for the professionals who run the campaigns it is about something much bigger than any of this: refighting the last presidential election.

The Democrats are hell-bent on exacting revenge for being cheated of victory in 2000. For their part, the Republicans are determined to prove that they were robbed of a clear mandate by a last-minute cock-up. Karl Rove, George Bush's chief political strategist, thought then that his man was coasting to victory; but the Democratic turnout was suddenly better than expected, and the Republican one worse. Mr Rove is particularly obsessed by the idea that 4m evangelical Christians who should have pulled the lever for Mr Bush simply stayed at home. Since then, he has done everything in his power to boost turnout among "people of faith" in general and evangelical Protestants in particular.

Mr Rove's analysis makes sense. White Protestants who describe themselves as born-again or evangelical make up about a quarter of the electorate—a bigger slice than blacks and Hispanics combined. They are particularly important in swing states where economic forces pull voters towards the Democrats but cultural ones pull them towards the Republicans. The University of Pennsylvania's National Annenberg Election Survey calculates that born-agains make up 36% of registered voters in Missouri, 30% in Iowa, 27% in Ohio and 22% in Pennsylvania.

But how likely is it that the Republicans can boost turnout among such an unpredictable group? It is hard to tell what is going on in the born-again world. Born-agains communicate through *Good News* magazine rather than the *New York Times*. And the Republicans don't exactly boast about their links with groups who claim that "liberals" plan to ban the Bible. But there are good reasons for thinking that born-agains will turn out in much greater numbers than they did in 2000.

The most obvious reason is that the turnout in 2000 looks like an aberration. Born-agains were disillusioned with politics in the wake of the Monica Lewinsky scandal. They were so shocked that Bill Clinton had got away with his adultery and lying that they turned against the political world en masse. And they were annoyed by the revelation, just a few days before the election, that Mr Bush had been convicted of drunk driving in 1976, not just because of the charge (though many regard drink as a demon) but because he had tried to cover up his behaviour.

The born-agains are in a different mood today: far more politically engaged and far more enthusiastic about Mr Bush. Paul Weyrich, the Catholic co-founder of the Moral Majority, thinks that the Republicans have probably recouped two-thirds of those 4m lost votes. And he has polling evidence on his side. Another Annenberg survey of 4,500 voters taken just before the Democratic convention showed that 51% of born-agains identified themselves as Republicans, compared with 22% as Democrats. The comparable figures in 2000 were 43% Republicans compared with 24% Democrats. A more recent poll by the Barna Group, a particular favourite with the White House, makes a distinction between evangelicals proper and the more general born-again population. But it points to similar conclusions: 54% of born-agains plan to vote for Mr Bush, and 90% of fully fledged evangelicals.

Religious groups such as Concerned Women for America and James Dobson's Focus on the Family are in a frenzy of activity these days. They have no shortage of issues to fire them up. Mr Dobson has described the fight against gay marriage as “our D-Day, or Gettysburg or Stalingrad”. But they are also struck by the contrast between the two candidates. They have bonded deeply with the president over the past four years on everything from stem-cell research to the war on terror. By contrast, John Kerry seems about as unappealing a candidate as you could get: a practising Catholic who disagrees with his church on many of its most fundamental teachings, and a Massachusetts liberal who doesn't have a clue about the born-again world (just 6% of Massachusetts voters are born-again, compared with 34% of Texan voters). And don't even get them started on Teresa.

The secular backlash

Conservative white Protestants are just the tip of a much larger religious iceberg in American politics. Mr Bush, an Episcopalian-turned-Methodist, has tried hard to reach out to all religious groups, including Muslims. And he has enjoyed particular success with Catholic voters. The Barna Group's poll shows that he now has a 53% to 36% lead among Catholic likely voters, a 22-point improvement in his position in the past four months. His support among observant Catholics is even higher.

Mr Rove's strategy of galvanising people of faith risks provoking a backlash from people of a more secular persuasion. The Republicans have done a passable job of flying under the radar as much as possible: talk to evangelicals about the Republican convention, and they will wax lyrical not about media heroes such as Arnie and Rudy but Joni Eareckson Tada, a quadriplegic who opposes stem-cell research, and Max Lucado, a bestselling religious writer. And initiatives against gay marriage have passed by huge margins. But it is easy to underestimate the power of secular America. The number of Americans who claim they have no religion has doubled over the past decade to 29m.

Regardless of the outcome of Mr Rove's strategy, America looks ever more divided along cultural lines. The Republicans are becoming the party of committed Christians, the Democrats that of committed secularists. The 2004 election could well turn into a choice between Michael Moore's “Fahrenheit 9/11” and Mel Gibson's “The Passion of the Christ”. Hardly an appetising development for those who didn't warm to either film.

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Crime and policing in Latin America

The battle for safer streets

Sep 30th 2004 | MEXICO CITY AND SÃO PAULO
From The Economist print edition

Reuters

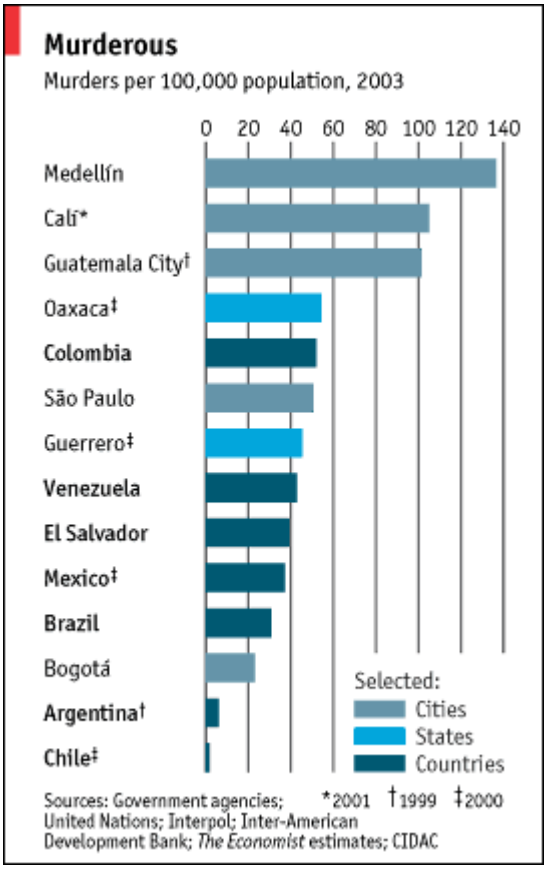
A long overdue and still incipient reform drive tries to turn the police into part of the solution to widespread crime

IN SEVERAL Latin American countries, 2004 will be remembered as the year in which the people rose up in revolt against crime. Hundreds of thousands poured on to the streets of Buenos Aires (first in March, and twice since) and of Mexico City (in June) in protest at crime and personal insecurity. In Brazil, earlier protests helped to generate support for a new law, which came into effect last month, placing tight new restrictions on gun ownership. Across the region, opinion polls show that crime is second only to economic worries as a public concern. Cracking down on it has become a votewinner: El Salvador's new president, Tony Saca, campaigned thus, as did Guatemala's Óscar Berger. Thanks to his unbending drive for “democratic security”, Colombia's president, Álvaro Uribe, enjoys greater public support than any of his counterparts in the region.

What brings so many Latin Americans on to the streets is a feeling of helplessness in the face of a woeful criminal-justice system. The statistics are patchy and unreliable. But in many countries, violent crime is rife (see chart). Some particularly nasty crimes are increasing, such as kidnapping in Mexico and Argentina. In Guatemala, more than 350 women have been murdered so far this year—many in execution-style. In Colombia, murders and kidnaps are decreasing—but other crimes are not. According to a survey of the three largest cities by the national statistics agency published last month, in 2003 in Bogotá there were 44 thefts an hour while in Calí 12 out of every 100 people had been a victim of crime. Despite Mr Uribe's efforts, only one respondent in three said they felt safer than the previous year.

Some of the causes of crime lie in socio-economic conditions: poverty and inequality; swift and chaotic urbanisation; joblessness, especially among young males whose numbers

have been swollen by a demographic bulge. The drug trade has created powerful criminal syndicates across the region. But above all, crime is common because criminals are rarely caught and punished. In Mexico, a recent study by CIDAC, a think-tank, found that 96% of crimes went unpunished between 1996 and 2003. Only around 8% of some 50,000 murders committed each year in Brazil are successfully prosecuted. As a result, many Latin Americans do not bother to report crimes: in Mexico, officials estimate that 75% of crimes go unrecorded.



Mistrusted, abusive and corrupt

Latin Americans see their police as part of the problem, not the solution. In this year's Latinobarómetro poll of 18 countries, only one respondent in three expressed confidence in the police (Chile is an exception, with 60% trusting the police). With reason: police are too often abusive, corrupt and incompetent—or even criminal.

After seven homeless people were murdered in São Paulo, Brazil's biggest city, in August, it came as no surprise when two of the four suspects turned out to be policemen. In Brazil, "the use of deadly police violence against civilians is rife," a United Nations investigator concluded earlier this year. In Argentina, two senior officers in the notorious Buenos Aires provincial force have been charged with taking bribes to turn a blind eye to the kidnapping of Axel Blumberg, a student whose murder in March triggered the protest marches. In Mexico, police have been involved in crimes ranging from mugging to drug-trafficking and kidnapping.

Some of what is wrong with Latin America's police forces stems from history. Under dictatorships, police were often militarised—and were the poor relation of the armed forces. Two things flowed from this—and still do. First, the police have traditionally seen their main job as keeping public order rather than preventing or solving crime. To do so, they often use quasi-military means. Take the policing of drug gangs in Rio de Janeiro's *favelas*. This is generally conducted like warfare, with invasion, battle—and collateral damage. When trafficking factions clashed in Rocinha, a Rio *favela*, earlier this year, the state government sent in 1,000 police and asked the federal government for army help. In quieter times, police keep their distance. They are schooled to react to crime rather than to prevent it.

Second, joining the police is not seen as a respectable professional career. Wages are poor, and abuse of lower ranks by superiors common. According to an official source, 60% of Mexico's police are in poor physical condition; in the Guadalajara state force, 45% of injuries to officers are self-inflicted gunshot wounds. In Brazil, ordinary policemen are barred from becoming officers. Training is woeful. At Brazil's police academies, training is "theoretical" and police are given "no skills", says Nancy Cardia of the Centre for the Study of Violence at the University of São Paulo.

Organisation is often poor, with too many different forces or units, each seeing the others as rivals. In response to corruption, governments have often opted for new, "elite" units, rather than root-and-branch reform. Dozens of different forces now operate in the Mexico City area. In Argentina, the government has sent units of the border police and a naval guard to the rustbelt suburbs of Buenos Aires.

In Brazil, the main responsibility for policing lies with state governments. Each has a "military police", whose job is to deter crime and make arrests, and a smaller, investigative "civil police". The two rarely co-operate. In some 300 cities, mayors have set up "municipal guards"; some of these act like full-fledged police forces. No force—with the possible exception of the well-paid federal police, which deals with smuggling, money laundering and fraud—has the training, equipment or structure to do its job properly.

The American-sponsored drug "war" has added other distortions. Colombia's National Police has world-class surveillance technology and a huge helicopter fleet to fight drugs, but is less good at dealing with ordinary crime. In Peru, specialised units to fight drugs, terrorism and other emergencies drained manpower and money from understaffed and demoralised local police stations.

Across the region, reform efforts of varying scope are under way. One response is to throw money at the problem. After the June protest, Mexico's president, Vicente Fox, flush with oil revenue, promised to double the public-security budget. That may not help much. Ernesto Portillo of the Institute for Security and Democracy, a think-tank in Mexico City, points out that since 2000 federal spending on public security has increased by $3 billion but reported serious crimes rose.

The reform agenda

In contrast, many reformers stress better management, cracking down on corruption and, in federal countries, merging or linking up different forces. They also want “community policing” (closer relations between the police and the public), and better police training and working conditions. Several of these measures are linked. “You can only do community policing if the population sees decisive leadership in cleaning up the police,” says Gino Costa, Peru's interior minister in 2002-03.

The pioneers were El Salvador and Colombia. As part of a 1993 peace deal ending a civil war, the UN organised a brand new civilian police force in El Salvador, whose recruits were drawn both from the previous militarised forces (which were abolished) and disbanded guerrilla armies. The new force is held accountable to the public through regular citizen forums and town meetings, mandated by law. That leads to “more crime reporting, better intelligence and better justice,” says Ricardo Menesses, the police chief.

In Colombia, national and local government have both made efforts to reduce violent crime. Mr Uribe has installed police stations in 158 towns that lacked them. After first studying patterns of violence, Antanas Mockus, twice Bogotá's mayor, reduced it with education campaigns and tighter regulation of guns and alcohol. Since 1994, Colombia's annual murder rate has fallen from 28,000 to 23,000.

In Peru, a team of civilian reformers took charge of the interior ministry, which was riddled with corruption during Alberto Fujimori's governments (1990-2000). Their wide-ranging changes included a purge of an absurdly top-heavy force (with 750 colonels but just 1,495 lieutenants in 2001); the setting up of a specialist anti-corruption office and of a police ombudsman to handle complaints from the rank-and-file; a shake-up of training; and various community participation schemes. Polls show the police have risen in public esteem. But the reform faced resistance from police commanders and from the party of Alejandro Toledo, Peru's president. The reformers were forced out earlier this year. Many of the changes are “still incipient and fragile and may be reversed...without civilian leadership and political will,” says Mr Costa.

In both Mexico and Brazil, experiments in reform are taking place at local level. In Aguascalientes, in central Mexico, the police academy has been turned into a new Institute of Public Security. Organised like a university, this offers professional qualifications in criminology and police work. Entrants are screened to eliminate “Hollywood types” whose main interest is in firing guns as well as those who might turn to crime themselves, says Lucila Guerra, the institute's young director. Graduates are rewarded with a higher salary.

In Brazil, under the federal government's “unified public-security system”, states that adopt its norms of good policing share in a 360m *reais* ($125m) fund, which makes a difference in the small, poor states of the north-east. Luiz Fernando Corrêa, the national-security secretary, says that the federal government will train 1,500 military policemen this year in crowd-control techniques. All states are being equipped with systems for retrieving fingerprint data, and encouraged to set up “integrated management centres” for their various police forces.

Much of the initiative comes from the states themselves. In Rio de Janeiro, an atrophied experiment in “community policing” is being revived in the wake of the Rocinha debacle. In São Paulo civil and military police jurisdictions have been aligned; a tough public-security secretary has speeded up sackings of corrupt police. But both São Paulo and Rio have resisted the federal government's push for “integrated management”, says Mr Corrêa.

Channelling public anger

Apart from internal resistance, reformers face two further obstacles. The first is that the police are only one link in the law-enforcement chain. While courts and prosecutors remain unreformed, better policing

alone will not ensure that criminals are punished. The second danger is that public anger leads to a self-defeating demand for mere repression. In several Central American countries, the police have been given draconian powers to arrest and lock up members of notorious youth gangs. But that hasn't cut the murder rate. In El Salvador, the gangs are responsible for 60% of all crime. Taming them requires preventative measures such as better education, tighter gun control and more jobs, argues José Miguel Cruz, a criminologist at the University of Central America.

In Argentina, the protesters' call for longer sentences ignores their effect on already overcrowded prisons. There, public pressure may make it hard for reform to mean much more than a purge of the police. In São Paulo, in the late-1990s, the state created an ombudsman to investigate police abuses; policemen who killed were given desk jobs and monitored by psychologists for six months. Killings by police dropped. But a crime wave has seen these measures weakened. Police killings have climbed again.

The task for Latin America's politicians is to respond to public anger while not allowing it to derail the long-term reforms of the police that are so urgently needed.

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Brazil's mayoral elections

Local skirmishes

Sep 30th 2004 | SÃO PAULO
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A test for a richer, slicker Workers' Party

Reuters

Lula looks to his coat-tails

THE headquarters of the Workers' Party (PT) in São Paulo is unremarkable on the outside but slick on the inside. Maps on the wall show where the party has candidates in Brazil's mayoral elections, whose first round is on October 3rd. Colour-coded reports, updated weekly, show how it is faring in the 96 biggest cities. Once mainly a metropolitan leftist party, the PT now has a presence in 94% of the country's 5,565 municipalities, and a communications network matched only by those of commercial banks, boasts Silvio Pereira, its secretary-general. Since Luis Inácio Lula da Silva won the presidential election for the PT in 2002, it has leapt ahead of its rivals in organisation and financial muscle.

Yet this well-tuned machine may not deliver a decisive victory. The PT could lose the biggest prize, the city of São Paulo. Overall, Mr Pereira expects to be able to declare a “narrow victory” by holding on to other big cities and making inroads in small districts. The party will have at least 500 mayors, he declares, up from 167 today, a view shared by some pundits.

The outcome will not directly affect Lula's government, but it will have national resonance. Anything that looks like defeat would demoralise the party and bolster its radical wing, which is opposed to Lula's macro-economic rigour. Victory might embolden the government to push controversial reforms, such as granting autonomy to the central bank, says Christopher Garman of Tendências, a consultancy. The local vote thus sets the stage for the second half of Lula's term, which will consist of a brief opportunity for enacting serious reforms followed by frenzied jockeying ahead of a general election in 2006.

It will help the PT that Lula's popularity, and the economy, are recovering after a bad patch. But in Brazil, mayoral votes turn on local issues, personalities and alliances. Although the PT has an edge in organisation, it governs just three smallish states. The centrist Brazilian Social Democracy Party (PSDB) governs eight, including such heavyweights as São Paulo and Minas Gerais. Governors generally trail longer coat-tails than the president; in smaller districts their patronage counts for more.

No candidate has tried harder to exploit Lula's popularity than Marta Suplicy, São Paulo's mayor. She faces a tough fight against the PSDB's José Serra, beaten by Lula for the presidency in 2002. Polls show them neck-and-neck. But in the second round on October 31st Mr Serra should glean more votes from supporters of defeated candidates. Mr Garman points out that in 2002 Lula's margin of victory in São Paulo city was much narrower than it was nationwide.

The PT could weather a loss in São Paulo if it does well elsewhere. Of the state capitals, it is likely to retain Belo Horizonte and Recife, and may win Curitiba. But the party could lose its stronghold of Porto Alegre, which would be a serious blow. In the 96 largest cities, 29 of which the PT already governs, it has improved its position in the polls in recent weeks, a sign that its professionalism and the economic upturn are helping. The PSDB is ahead in 20. So the election may consolidate the role of the PT and the PSDB as Brazil's leading parties.

If the PT does well, 2005 could be the most productive year of Lula's presidency. There are pending reforms to enact, such as a bankruptcy law and a measure to encourage private investment in public works, and talk of more ambitious steps to follow. Add up millions of local choices, and they may have a national effect.

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Panama and Colombia

Minding the Gap

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Still no last link for the Pan-American Highway

STARTING either from northernmost Alaska or from southern Chile, one can drive to the Panamanian province of Darién. But the 16,000-mile (25,750km) Pan-American Highway—a project that started in 1936—stops short on either side of a sparsely populated stretch of jungle 54 miles wide known as the Darién Gap. For more than 40 years, this has been the highway's only missing link.

Colombia's president, Álvaro Uribe, wants to connect his country to Central America by road at last. But although, thanks to foreign aid, much of the dirt track connecting Panama City to Yaviza, at the edge of the Gap, has been paved in the last few years, the highway will not be completed anytime soon.

Mr Uribe wants closer links with Central America, whose countries are becoming more closely integrated with each other. The Inter-American Development Bank (IDB) estimates that the improved cargo routes it is funding in seven Central American countries and Mexico could increase annual trade flows between them from $5.1 billion to $8.5 billion. A highway would give Colombian exporters easier access to that market. And building a road to Panama—itself part of Colombia until 1903—would be popular with many Colombians. It might also make it easier to control the flow of guerrillas, paramilitaries, drugs and contraband across the border.

But Panama's new president, Martín Torrijos, is as cool to the idea as were his predecessors. According to Nils Castro, Mr Torrijos's foreign-policy adviser, the government fears that a road would damage Darién's jungle ecosystem, and thus its fast-growing eco-tourism industry. He says that Panama would prefer to fortify trade links by air and sea instead.

Mr Uribe will probably have to settle for his other two proposals: an electrical interconnection and a gas pipeline. Colombia produces cheap electricity and has excess capacity, and through a line to Panama it could eventually power much of Central America. And the gas pipeline, which would run from Venezuela through Colombia to Panama, could be routed along the coast to avoid environmental damage. Mr Castro says that Panama is interested in both projects. But the road will have to wait. “It's a longstanding Panamanian position,” says an IDB official. “They like the gap.”

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Oil in Asia

Pump priming

Sep 30th 2004 | BANGKOK AND JAKARTA
From The Economist print edition

Reuters

Dear oil and subsidised petrol are hurting Asia's economies

THE high price of oil is taking a serious toll on Asia, in more ways than you might think. Inflation is already ticking up, from Mumbai to Manila. Interest rates are beginning to follow. Increased energy costs, the United Nations reckons, will shave a percentage point off the region's economic growth this year. The Asian Development Bank has just cut its growth forecasts for next year too. In some cases, the prognosis is truly dire: prices of $50 a barrel, if sustained throughout next year, will slash four percentage points off Thailand's growth rate, according to the bank's projections. Yet many Asian governments, including Thailand's, are making a bad situation worse by subsidising fuel prices.

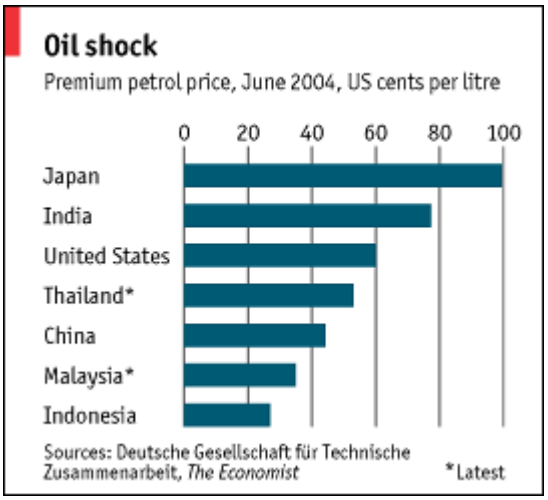
The economies of Asia, like those of most developing countries, are oil-intensive. In other words, Asians consume more oil per unit of output than Europeans or even gas-guzzling Americans. Thailand and China, for example, use more than twice the rich-country average, while India burns through almost three times as much, according to the International Energy Agency. So they naturally suffer more when the oil price rises.

One reason Asian countries get through so much oil is that many of them subsidise it in one way or another. Since the beginning of the year, the Thai government has fixed the retail price of diesel at below market rates, at its own expense. Indonesia has long done the same for all types of petrol. In August, the Indian government cut excise and import taxes on oil, to add to the direct subsidies it already pays on liquefied petroleum gas (LPG) and kerosene. Malaysia, too, keeps petrol prices low through direct subsidies and tax breaks. The government of China sets discounted prices, but leaves it to refiners and distributors, which are largely state-owned, to absorb the shortfall.

Needless to say, all this costs a fortune. The Indonesian government originally planned to spend 14 trillion rupiah ($1.5 billion) on fuel subsidies this year. But as the oil price has risen, the bill has more than quadrupled, to 63 trillion rupiah. That is almost as much as Indonesia's total budget for development. In Malaysia, fuel subsidies and forgone taxes account for roughly half this year's budget deficit of 20 billion ringgit ($5.3 billion). Rating agencies have been muttering about the government's persistent deficits, yet it left the fuel subsidy intact in next year's budget too. India, another compulsive borrower, is spending $1.4 billion this year to subsidise kerosene and LPG alone. The government is also forgoing $540m in tax revenues on various fuels, while state-owned refiners and distributors must also have absorbed considerable costs that do not feature on the government's balance sheet.

Taxpayers, of course, will eventually foot all these bills. Meanwhile, growing public debt puts upward pressure on interest rates and reduces the capital available to more productive borrowers. In the long run, that could cause far more damage than high oil prices.

To make matters worse, artificially low prices encourage waste, along with all the concomitant costs in terms of pollution, traffic congestion and misallocated capital. Thaksin Shinawatra, Thailand's prime minister, claims he is determined to reduce his country's energy bills. To save electricity, he has asked shops to close early and that big buildings should switch off their flood-lights. Yet since January, he has capped the price of diesel—on which most Thai vehicles run—at about three-quarters of the market rate. Motorists, naturally enough, are buying more. Thailand's oil imports have duly surged in volume, as well as just price.



Higher import bills, in turn, have sent Thailand's trade balance into the red. That has depressed the baht, making imported fuel more expensive still, and feeding the inflation the subsidies are supposed to curb. Most Asian nations import at least some of their oil; of all the countries mentioned, only Malaysia is a net exporter. Indeed, Asia as a whole (excluding the Middle East, but including Central Asia) produces only 11% of the world's oil, but consumes about 21%. Oil alone accounts for almost a third of India's imports, for example. Admittedly, a healthy balance of payments and huge foreign-exchange reserves will allow most Asian countries to finance expensive oil imports for a long time to come. But there is no sense in increasing the burden unnecessarily.

Furthermore, most oil subsidies do not go to the people in whose name they are paid: the poor. Cheap petrol, for example, benefits most those who drive the biggest, most inefficient cars, namely the rich. The poorest have no motor vehicles at all. Indonesia effectively subsidises its richer neighbours, thanks to a roaring trade in smuggled petrol. Singapore does not allow locally registered vehicles to leave the country with less than three-quarters of a tank of gas, to prevent them from taking undue advantage of the subsidised stuff across the border in Malaysia. Even targeted subsidies can end up in the wrong hands. Many countries subsidise kerosene, since the poor often cook with it. But so do lots of well-to-do restaurateurs.

The biggest beneficiaries of oil subsidies are the politicians who use them as a crude vote-buying technique. Mr Thaksin has declared that diesel subsidies will remain in place until February, which also happens to be the month by which an election must be held. The previous Indian government did not allow any fuel price rises for five months prior to elections in April. The outgoing Indonesian government, too, put off planned price hikes this year. How unlucky, then, that a record year for oil prices also happened to be a record year for elections in Asia.

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Australia

The contender

Sep 30th 2004 | BRISBANE
From The Economist print edition

Labour's feisty leader takes the election down to the wire

Get article background

Reuters

Latham is in with a chance

MARK LATHAM has come from nowhere to give Australia's opposition Labor Party a real chance of winning the country's general election on October 9th. He has rattled John Howard, the prime minister who is seeking a fourth term for his conservative coalition government. He has made Australians listen to Labor for the first time in more than eight years. He is also asking them to take a risk by trusting their booming economy to someone who many feel they still do not know.

On September 28th, the day before Mr Latham launched Labor's campaign in Brisbane, the state capital of Queensland, an opinion poll gave Labor a lead over the coalition by 52 points to 48. It was a remarkable turn-around from last December, when Mr Latham took over the leadership. At that time Labor seemed a political write-off. With some exceptions, opinion polls since mid-August have given Labor an election-winning lead after the distribution of second-preference votes from small parties, mainly the Greens. This may be a signal that the challenger's decision to fight the election on domestic issues, especially on education and health, rather than Mr Howard's familiar turf of security and the economy, is starting to resonate.

Mr Howard hit back when he too launched the coalition's campaign in Brisbane, a city both leaders chose because Queensland's swinging electorates will help decide who wins. The prime minister doled out A$6 billion ($4.2 billion) worth of promises for schools, small businesses, child carers and apprentices, and gave warning that Mr Latham's inexperience in running the economy would bring back the high interest rates of a former Labor government. Some senior economists questioned the prime minister's assertion. Bernie Fraser, a former governor of Australia's central bank, this week accused Mr Howard of “scaremongering” and “fiscal profligacy”.

Mr Latham has tried not so much to match the prime minister's profligacy as to differentiate the way he would spend dollops of public money. He proposes to take A$520m from Australia's 67 richest private schools, which have benefited under the coalition, and redistribute it among poorer private schools, while pumping another A$1.9 billion into state schools. He promises another A$1 billion for public hospitals and to revive Medicare, the public health-insurance system, and to give free hospital care to elderly people, core coalition supporters.

Much of Mr Latham's pitch derives from his own experience growing up poor in Green Valley, in Sydney's sprawling western suburbs. He has since written or edited nine books. If elected, he will possibly be Australia's most intellectual prime minister. His learned image is at odds with his famed capacity for crude political invective, which he has toned down since becoming leader. The best insult he could offer at his Brisbane launch was to portray himself, at 43, as “ready to lead” against Mr Howard, at 65, as “ready to leave”.

He has shown a desire to rewrite the rules since taking on his first elected job, at the age of 30, as mayor of Liverpool in western Sydney. His first acts were to remove a picture of the British queen and send the mayor's robes and chain to a museum, saying the council needed a more mature identity.

More than any Labor leader before him, this one has recognised the Howard government's skill in

appealing to those who live in the suburbs and worry more about how to bring up their children than about grand political gestures. Mr Howard's tough stand on security and asylum-seekers at the last election in 2001 won him a swag of seats in the heavily-mortgaged western fringe of Sydney that Labor once considered its heartland, and which it must now take back to win government. Mr Latham's earlier pledges to make a formal apology to aborigines and to restart the debate on an Australian republic have barely featured in his campaign.

Equally, he has tried to play down one of Labor's most vulnerable points: its policy of returning to trade unions the power to negotiate wages on a collective basis. This plan, which gives the business world the jitters, was decided before he took over as leader. Recently he tried to calm employers by suggesting that the role unions play in a market economy “will depend on their capacity to be relevant to the workplace”. Nonetheless, his big test in government would be to stare down the power of the old union elites.

In the end, Australians may still be swayed by Mr Howard's economy and security package, and conclude that his opponent needs more time to prove himself. But either way, Labor's new leader seems destined to stay in the limelight.

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Afghanistan's election

Deeply flawed

Sep 30th 2004 | MIHTARLAM
From The Economist print edition

Yet Afghans are passionately keen to vote

Get article background

Reuters

Karzai nearly drops in

“IN THE name of Allah the merciful,” intoned pious officials, proclaiming the coming of democracy to Mihtarlam this week in front of a crowd of long-bearded elders. The officials promised that new roads would soon reach the town, a dust-trap in Afghanistan's violent south-east. New schools would also be built. Sadly, the man who they said would deliver these gifts, Hamid Karzai, Afghanistan's American-backed ruler and the favourite to win the presidential election, could not attend the rally to say all this in person. He was afraid of being assassinated.

In the history of flawed elections, it is hard to think of a more precarious poll than the one Afghanistan is preparing for on October 9th. Most of the country is considered too dangerous for the leading candidates, or the United Nations officials running the vote, to visit. Mr Karzai was forced to abort his only attempt at a campaign rally to date, after his helicopter was fired on as it tried to land in the south-eastern town of Gardez. While the UN's foreign staff have stayed in Kabul, a dozen local employees have been murdered by Taliban insurgents, and scores badly wounded. Both the UN and the security experts it has hired have warned the government not to deploy its fledgling army and police into the roughest provinces during the vote.

In part as a result of this, many polling stations will be guarded by the local opium-enriched strongman, of whom Afghanistan has an abundance. This makes it especially worrying that the European Union and other foreign organisations have found fewer than 200 observers to monitor 5,000 polling stations. Since they will not be able to observe very much, they will not, in fact, be known as election observers. So they are being called “democracy support teams” instead.

Given these imperfect conditions, many people have dismissed the imminent election as a publicity stunt designed to buttress George Bush's own re-election campaign. But the fact is that Afghans seem eager to vote. A rough estimate puts the size of the electorate at 10.5m. Almost that many appear to have registered for the poll. A large portion may turn out to be bogus: there have been reports of the same people registering numerous times, whether in the hope that their registration cards will be worth money, or simply for the pleasure of being photographed. According to other reports, many teachers have been registering their pupils. Even Pakistanis are said to have registered in droves, after slipping across their north-western border. In one of the Afghan border provinces, Paktia, voter registration reached 170% of the target.

All the same, if only half of those registered actually vote, this will be a remarkable achievement in a country that has never before elected its leader. And if, despite the obstruction of the warlords and the Taliban, Mr Karzai wins his expected majority, the election could suggest a new commitment to a reconstruction effort that has been widely derided for its failure to bring peace or prosperity.

Against this, of course, is the danger that the election will raise the expectations of the people only to disappoint them again. Instead of campaigning, many of Mr Karzai's 17 opponents, including one or two with unsavoury war records, appear to be negotiating with him to extract jobs in the next government in return for withdrawing from the contest. Several local politicians accuse America's wily ambassador, Zalmay Khalilzad, a native Afghan, of leading these negotiations. The ambassador denied the charge,

then added: “It is true that I do talk to these fellows.” An election that leaves all the same faces in power will disillusion a lot of Afghans.

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Japan

Loyal to the Lionheart

Sep 30th 2004 | TOKYO
From The Economist print edition

The new cabinet will stress trade deals, financial reform and foreign affairs

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AP

Yet another job for Takenaka

JUNICHIRO KOIZUMI remains as stubborn as ever. The prime minister, who reshuffled his cabinet on September 27th, once again ignored the wishes of his Liberal Democratic Party's heavyweights, and instead chose cabinet members and party leaders who back his policies. His decision to put Heizo Takenaka, the banking-and-budget tsar, in charge of privatising the ¥350 trillion ($3.18 trillion) postal savings-and-insurance system stole the spotlight. Mr Takenaka has been the cabinet's most visible minister, and postal reform has been Mr Koizumi's pet project for decades. But the prime minister's choices also showed the importance of free-trade talks and Japan's evolving diplomacy.

Mr Koizumi replaced the foreign and defence ministers, and plans to keep running a good deal of foreign policy from his own office. He named a close ally, Taku Yamasaki, as a new informal adviser, and appointed Yoshinori Ono, who wants to upgrade Japan's military, as the new minister for defence. Japan and the United States are discussing an extensive review of America's 47,000 troops and numerous bases in Japan, as part of a global American defence overhaul.

Yoriko Kawaguchi, the outgoing foreign minister, will advise Mr Koizumi on Japan's bid to gain a seat on the UN Security Council. Those special advisers must get along with the new foreign minister, Nobutaka Machimura, who may not be content just to run the bureaucracy and make nice speeches. Mr Machimura's first order of business, however, was to explain his stance on the Yasukuni shrine, which honours war criminals along with Japan's other dead soldiers. Mr Koizumi's annual visits to the shrine have infuriated Japan's neighbours, and Mr Machimura likes to go there too. But, without criticising Mr Koizumi's trips to the shrine, Mr Machimura now says he may stop his own.

On trade, Mr Koizumi is sticking with a clever experiment. He has left Shoichi Nakagawa, who has strong ties to farmers, in charge of the economy, trade and industry ministry, which negotiates trade deals. Although powerful and protectionist farmers have long stymied trade talks, Japan's businessmen are calling loudly for new deals that make it easier to export and invest overseas. Mr Koizumi has backed the businessmen. He appointed Mr Nakagawa last year, hoping that knowledge of farm politics would make it easier to overcome resistance and cut fresh trade deals. Free-traders in the civil service like the idea, which has begun to deliver results. Japan has just signed a bilateral deal with Mexico after agreeing to import more orange juice and pork.

Although Mr Takenaka has changed roles, reforming the financial system remains a priority. It is hoped that Tatsuya Ito, who had been Mr Takenaka's financial-services deputy, will extend recent banking reforms to regional banks. These must be properly audited, and some of them need to be overhauled. Mr Takenaka, meanwhile, will no doubt stay in the spotlight. Shigenori Okazaki, a political analyst at UBS, reckons that 70% of the LDP's lawmakers oppose the postal reforms that he must now drive through parliament.

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Taiwan and China

Tit for tat

Sep 30th 2004
From The Economist print edition

A missile spat

Get article background

IS THE war of words between China and Taiwan in danger of tipping over into something a lot nastier? Taiwan's prime minister, Yu Shyi-kun, this week abandoned the official line that the island, which China claims as its own, seeks only defensive weapons. He suggested for the first time publicly that Taiwan should consider building a missile force with the aim of establishing a “balance of terror” to fend off China's threats. “If you fire 100 missiles at me, I should be able to fire 100 missiles at you, or at least 50,” he said. “If you strike Taipei and Kaohsiung, I should at least be able to strike Shanghai.” China, predictably, called this a “serious provocation”. Yet Taiwan has yet to deploy a single such missile, while by its count China has now pointed over 600 directly at it.

According to Bates Gill of the Centre for Strategic and International Studies, a think-tank, Mr Yu's blunt comments are part of a much bigger debate about how Taiwan can best defend itself. That debate in turn is part of a wider public discussion of the increasingly tricky strategic situation Taiwan faces in its efforts to fend off pressure for reunification. That pressure has intensified since the Taiwanese voted earlier this year to re-elect their independence-minded president, Chen Shui-bian.

Some on Taiwan argue that the defensive weapons America helps the island to acquire, including a controversial $18 billion arms package first offered three years ago by the Bush administration and only now under debate in Taiwan's parliament, may not be enough to keep a stable cross-strait balance. They worry that Taiwan's armed forces will need years to integrate the new equipment, which includes diesel-powered submarines, anti-submarine aircraft and Patriot anti-missile batteries (next year, America may also offer ships equipped with advanced Aegis radar systems). The China threat is nearer-term and growing. It would thus be cheaper, quicker and more effective, some argue, for Taiwan to develop missiles of its own.

America has always discouraged that, although Taiwan has tinkered about with ballistic-missile technology for years. According to the *Liberty Times*, a Taiwanese newspaper, the armed forces recently tested new cruise-type missiles with a range of at least 150km (90 miles). With upgraded guidance systems, and mounted on ships in the Taiwan strait, these could hit targets in some Chinese cities.

America has sought to dampen the row, calling on both sides to take no unilateral action. But whatever its missile plans, part of the Taiwan government's aim this week was to keep the spotlight on China's own missile build-up, which it points out is the real threat to the status quo. At the same time there are reports that China is considering temporarily setting aside insistence on its “one-China principle” in working out a framework to get Taiwan to the negotiating table. It doesn't necessarily expect Mr Chen to take up the offer. But that would be a way to shift the blame for the tension back on to Taiwan.

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Tonga

Royal air foes

Sep 30th 2004 | CHRISTCHURCH
From The Economist print edition

The airlines and the palace

"WHEN government fails, it is the king who has failed," wrote Kalafi Moala recently. Mr Moala is publisher of the banned Auckland-produced newspaper *Taimi 'o Tonga* (Times of Tonga) and a longstanding critic of Taufa'ahau Tupou IV, Tonga's 86-year old king. He was writing in the wake of a court battle over rival efforts to establish a new airline in the South Pacific kingdom, the sacking of three cabinet ministers, and demands for the resignation of the prime minister, 'Ulukalala Lavaka Ata—who is also the king's youngest son.

It all began when the Royal Tongan airline collapsed last April, starting a row about who had rights to establish an alternative domestic carrier. The normally staunchly monarchist Kotoa Movement has joined calls for the prince-prime minister to step down. It backs the claims of Peau Vava'u (Air Waves of Vava'u), against those of flyNiU Airlines, a rival set up by Royal Tongan staff.

Peau Vava'u is part-owned by the king's eldest son, Crown Prince Tupouto'a, heir to the throne, who also has substantial stakes in breweries, electricity generation, telecommunications and property. Tupouto'a, a Sandhurst-educated 56-old bachelor who occasionally drives around the main island in a London taxi, reportedly ordered the grounding of flyNiU, triggering a right royal row with his brother, the prime minister. This is what culminated in the sacking of the three ministers.

The efforts of Mr Moala and the Tongan Human Rights & Democracy Movement to make common cause with the monarchists of Kotoa shows the difficulty of campaigning for more democracy in Tonga. At present, the king appoints the prime minister and cabinet, as well as 12 of the 30 MPs. Another nine MPs are selected from among the holders of 33 noble titles, leaving only nine to be elected by Tonga's 100,000 "commoners". There is no way to dislodge the monarchy—unless the king agrees.

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Nigeria

Gunmen and reformers

Sep 30th 2004 | ABUJA
From The Economist print edition

AFP

Let's be prudent, says the finance minister

No, let's not, say the gunmen of the Niger Delta

Two forces pulling Nigeria in opposite directions

Get article background

WITH oil nuzzling $50 a barrel, Nigeria should be doing rather well. The trouble is, the demand for easy money is infinite, and many Nigerians are reluctant to wait quietly for the government to share it out. A group called the Niger Delta People's Volunteer Force, for example, threatened "all-out war" against the Nigerian government this week unless it granted "self-determination" to the oil-producing Niger Delta region. In other words, give us money or we'll shoot.

It is unclear how big a threat the Delta fighters pose. Their leader, Mujahid Dokubo-Asari, says he has 200,000 men. Other observers guess he has only a few dozen armed followers. The government says he is a small-time thief and a "joker".

But he has links with local politicians and at least some support from members of his tribe, the Ijaw, who are a majority in the Delta. What is more, there are plenty of other Ijaw gangs that might make common cause with him. Fighting between the gangs and the army claims about 1,000 lives a year in the Delta, and the gunmen managed briefly to shut down 40% of Nigeria's oil production last year. The government does not want that to happen again, so it is negotiating with Mr Asari. On September 29th, he said a ceasefire had been agreed.

The Niger Delta is like an unpleasant caricature of Nigeria itself. Per head of population, it receives much more oil money from the central pot than any other region. But the cash is largely squandered by corrupt politicians, so its people feel permanently aggrieved. Few imagine that the oil money will ever be fairly divided, so most argue instead that more of it should be lavished on themselves and their ethnic kin. Some, such as Mr Asari, are prepared to fight for this noble ideal.

In the short term, Mr Asari's crew can doubtless be bought off or, failing that, crushed militarily. But in the long term, the Delta will never be calm, and Nigeria as a whole will never prosper, until the country's endemic corruption is curbed. So long as power is an easy route to wealth, the wrong sort of people will seek it.

Nigeria's president, Olusegun Obasanjo, understands this. During his first term, between 1999 and 2003,

he did little to fight corruption, but his advisers plead that this was because he had his hands full consolidating democracy after years of military rule. In his second term, they say, he will grapple with it.

To this end, he has appointed a group of young, hard-working technocrats to certain key posts. The finance minister, a former World Bank vice-president called Ngozi Okonjo-Iweala, is striving heroically to make public finances more rational and transparent.

Details of how much money has been disbursed to each level of government are now published on the internet. Civil servants are having their benefits monetised: instead of free housing, electricity, official cars and so on, they are given cash allowances. Quite senior officials can now be seen hailing taxis. Mrs Okonjo-Iweala actually waits her turn in the airport queue.

More competitive bidding for public contracts has saved 118 billion naira ($1 billion) in the past three years, she says. Spending has been more prudent than in the past, tax-collection more effective, and the macroeconomic situation, partly due to oil prices, is better than it has been for years. The IMF and some investors are impressed. This week Sir Richard Branson's Virgin Atlantic Airways announced plans to launch a new airline in Nigeria.

The reformers do not have much time, however. In 2007, the president will be out of office and so, probably, will they. Before the election campaign begins, they must put in place enough checks and balances to make it hard for politicians to carry on filching. Among these is a “fiscal responsibility” bill, which Mrs Okonjo-Iweala says will pass next year. It would boost the reforms, she argues, if rich countries would cancel Nigeria's odious debt.

Nigerians like what she is trying to do. Strangers accost her to wish her luck. But, having been let down before, many remain sceptical. Doubters note that no top-level politicians have been convicted of anything. To be fair, this is partly because the courts are slow and dirty, but presumably Mr Obasanjo could purge the judiciary, as Kenya's president recently did.

There have been several prominent arrests and dismissals. Mrs Okonjo-Iweala points with pride to a clean-up of the customs service and the netting of 500 suspected advance-fee fraudsters, who tarnish Nigeria's image by filling the world's inboxes with criminal spam.

Locking up scamsters is a good idea, of course, but it is hardly as crucial as thwarting those who embezzle the funds that Nigeria should be spending on roads and schools. Unfortunately, such people are frustratingly powerful. Another reformer, Nasir el-Rufai, the minister for Abuja, the capital, guesses that barely 5% of Nigeria's elite back the fight against graft.

Even those who would prefer to stay clean face immense pressure from their relatives, acquaintances and ethnic kin to grab as much as they can and dole it out. Donald Duke, one of the more reputable and effective of the country's 36 governors, illustrates the point by reading out a text message he has just received.

“Darling Donald,” it says, “When would you like to see me so we can discuss the house problem?” “My aunt thinks I should buy her a house,” explains Mr Duke, adding that he receives similar requests “every minute of every day”. How does he cope? “You learn how to say no. [But] they'll never stop asking.”

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UN Security Council reform

Room at the top table?

Sep 30th 2004 | JOHANNESBURG
From The Economist print edition

Africa wants a seat, but can't agree who should sit in it

Get article background

REJIGGING the UN's Security Council is proving as tricky as expected. A “high-level” committee looking at this and other UN reforms has just produced, though it has not yet published, its first draft of ideas. Experts at a retreat near New York pored over it this weekend.

The main questions are whether and how to expand the council beyond its current 15 members.

Kofi Annan, the UN's secretary general, wants a final report on the subject by December. What he will do next is not clear. Everyone agrees that it is anachronistic that only the four victors of the second world war (America, Russia, Britain and France), plus China, have permanent seats and a veto. But that is all anyone can agree on.

Germany and Japan are most anxious for new permanent places, though not necessarily vetoes, on the grounds of their economic clout and generous contributions to the UN's budget. Last week, leaders of the two countries, plus those of Brazil and India, launched a joint bid for seats, adding that Africa should get one too. Britain and France also back a permanent spot for Africa.

A seat for Africa makes sense. After all, its wars and other troubles occupy roughly half of the Security Council's time. But which of the continent's 53 countries should occupy it?

Egypt and Nigeria would both like to volunteer. Senegal suggests that Africa should have two seats, one for Francophones, the other for English speakers. The idea of electing countries to five-year terms as semi-permanent members has several supporters.

The most likely choice, however, is South Africa. Stable, democratic and not too corrupt, it is also easily Africa's biggest economy. Its army already provides two battalions of UN peacekeepers, in Burundi and Congo. And it wants a seat. On September 24th, President Thabo Mbeki said, for the first time, that South Africa “is ready to serve the people of Africa and the world”, by sitting at the UN's high table.

Mr Mbeki was previously coy about that, perhaps hoping to get Africa to agree on just one bid (his own). That would have been clever. Now Africa will squabble over a candidate, just as every other part of the world is doing. Mexico may compete against Brazil to represent Latin America; Pakistan opposes India; Italy is campaigning against Germany. And the more the outsiders fight, the less the chance that any of them will be admitted to the club.

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Egypt

The cacophonic call to prayer

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But it's evocative, say some

SOME 10,000 loudspeakers, all blaring at once: is this an ad man's fantasy or the latest pop concert gimmick? No, the idea was cooked up by Egypt's Ministry of Religious Affairs. It plans to hook all the mosques in Cairo to a city-wide wireless network, so that five times a day they can amplify the Muslim call to prayer in a single voice, in the same instant.

The scheme, which has been approved but awaits “technical studies”, is not without critics. Some complain on aesthetic grounds. Cairo is famed as the “city of a thousand minarets”. Although today's megalopolis of perhaps 15m inhabitants has more than 5,000 mosques, many of them fitted with multiple megaphones, the call to prayer still cascades across the city like a musical round, in differing pitches and tones and decibels, as it has for centuries. Uniform and in unison, the sound would lose its resonance, say some. Besides, it would put the *muezzins* who call the faithful to prayer out of work.

Fiercer critics say the idea is *bid'a*—an opprobrious term for irreligious innovations. Some clerics accuse Egypt's government of bowing to what they imagine is American pressure, as part of Washington's perceived campaign against Islam. What's next, demands one irate Islamist website. Are we to pray in front of a television set, towards televised images of Mecca?

Nonsense, say the authorities. The plan is needed to uphold Islam's “civilised face”. The religious-affairs ministry says it is barraged with complaints about the poor timing, excessive loudness and harsh voices of many *muezzins*. The religious revival that has swept Egypt in the past two decades has packed the country with more mosques than it needs. It is common to find two or more houses of worship on one city block, competing to be noticed. Worse yet is a fashion, imported from Saudi Arabia, of rendering the call to prayer in a deliberately flat, toneless drone, to avoid the stigma of sounding like music, which some strict Muslims believe to be sinful.

So the religion ministry has armed itself with powerful *fatwas* from Egypt's most senior clerics. The Prophet Muhammad himself picked a man with a beautiful voice to perform the first public calls to prayer, notes the minister, insisting that he plans to choose from among Egypt's most renowned Koran reciters. Besides, he adds, if anything amounts to dangerous “innovation”, it is the loudspeaker itself.

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Syria and its neighbours

A troublemaker surrounded

Sep 30th 2004 | BAGHDAD AND CAIRO
From The Economist print edition

A regime accused of backing terrorism wilts a bit under American pressure to stop

Reuters

A subtle message to those who harbour Hamas

A CAR bomb went off in Damascus, Syria's sleepy capital, on September 26th, killing a top leader of Hamas, the Palestinian militant group. A day later, across the border in Lebanon, a man accused of heading a local al-Qaeda cell died in police custody, “of a heart attack”.

These two events may appear unrelated, but both reflect a subtle shift in the shadowy great game between, on the one hand, America and its allies, and on the other, Syria, an ailing regional power, and its government's motley friends. Having encircled Syria by occupying Iraq, the American team is now squeezing harder. The government in Damascus, which has long feigned blithe unconcern—to the extent of portraying a recent censure of its policies by the UN Security Council as a diplomatic victory—is feeling the pressure.

The killing of Ezzedin Sheikh Khalil, a little-known but senior member of Hamas, was a straightforward assassination, almost certainly carried out by Israeli intelligence. Many other Palestinians said to be involved in terrorism have met the same fate, but this would be the first time Israel has struck in the heart of a Syrian city.

While coyly dodging an open admission of guilt, Israeli officials hint that the killing should be taken as a blunt message. It was meant to warn that Hamas will be targeted anywhere, and that Syria, which Israel accuses of harbouring terrorist groups, should stop doing so or risk further punishment from its immensely better-armed neighbour.

Syria justifies its harbouring of Hamas members on various grounds. It argues that the Palestinians' struggle against Israeli occupation is legitimate, and that, besides, Hamas conducts only “information activities” from Syrian territory. It adds that it has long felt a duty to shelter Palestinian refugees of every stripe.

Whatever patience foreign capitals may once have had for groups such as Hamas, and for Syria's succouring them, appears to be wearing thin. The Israeli hit provoked barely a blink from the outside world. America, bloodied in Iraq, no longer feels constrained to rein Israel in, despite the fact that Syria has for months been putting out feelers, through the Americans, in the hope of resuming peace talks with the Jewish state. Israel's prime minister, Ariel Sharon, has now made it clear that he does not care to talk.

If Syria's ill-fated peace overtures are one response to American pressure, the death of that Lebanese al-Qaeda suspect may have been another. A known Islamist militant, Ismail Khatib was nabbed last week with ten others, and charged with plotting local terrorist attacks, as well as with recruiting men to fight the Americans in Iraq. The arrests raised eyebrows in Beirut, for several reasons.

Mr Khatib's hometown, Anjar al-Majd, lies a few miles from the Syrian border, and just across the main Beirut-Damascus highway from the headquarters of Syria's 15,000 troops keeping a watchful eye over Lebanon. While many Lebanese believe the terrorism charges against him were fake, it is hardly a secret that recruiters for the Iraqi insurgency have been active in poor, Sunni Muslim areas such as Mr Khatib's village, as well as in Palestinian refugee camps. It is no secret, either, that these places are tightly

controlled by Syrian intelligence: such recruiting could not be pursued without a wink from Damascus.

A sense of betrayal

This was certainly no mystery in Anjar al-Majd. Dozens of young men from the village are known to have joined the *jihad* in Iraq, whence at least two have returned in coffins. What particularly angered villagers about Mr Khatib's suspicious death was that no official had ever told them that recruiting for the *jihad* against the American infidel invaders was wrong. As they see it, Mr Khatib was the victim of a sudden switch in Lebanese (for which read Syrian) policy. No wonder the village erupted in riots, with rampaging Islamists cursing Lebanon's interior minister and calling him a “Rumsfeld”.

Syria's troublemaking in Iraq, whether by omission or commission, infuriates both America and the Iraqi interim government. Iraq's prime minister, Iyad Allawi, estimates that 30% of the insurgents in Iraq are foreign. This sounds far-fetched, but visitors to Fallujah, one of the most rebellious Iraqi towns, say that masked fighters with Syrian accents are everywhere. They are especially noticeable at checkpoints run by the most hardline groups—the ones that take hostages and let off bombs in crowded streets.

Money for the insurgents also seems to cross the Iraqi-Syrian border without impediment. The Iraqis say that Syrian intelligence could easily intercept suspicious travellers if they wanted to. But they don't, say the Iraqis, because they would rather the Americans were too bogged down in Iraq to start thinking about regime change in Damascus.

Syria denies all this, and is making a great show of trying to put a stop to *jihadi* recruitment in Lebanon. This is probably in response to quiet American threats. It also comes shortly before a report on Syrian behaviour is to be presented to the UN Security Council on October 3rd. The day marks the end of a month-long period during which Damascus was meant to address concerns, chief among them its maintenance of troops in Lebanon. It is by no means certain that the crackdown on *jihadi*s, along with this week's cosmetic withdrawal of a few thousand Syrian soldiers, and earlier promises to seal its border with Iraq better, will be enough to get the superpower off Syria's back.

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Demographic change

Old Europe

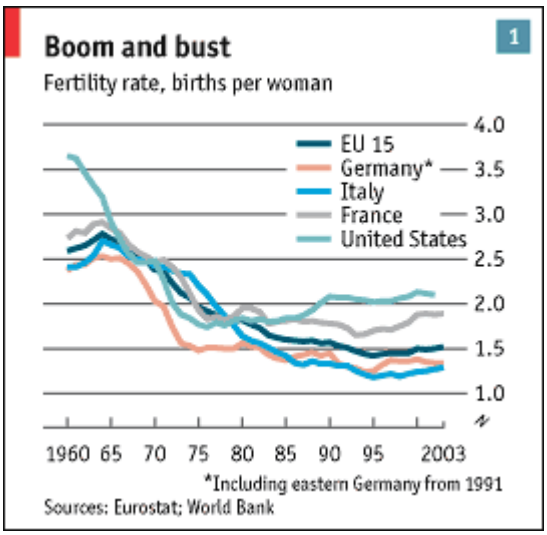
Sep 30th 2004
From The Economist print edition

Alamy

Ageing populations will hurt Europe's economies and put pressure on budgets—and there are no easy solutions

AMERICANS have long seen Europe as the old world. Now they have another reason to count the difference. Europe is ageing much faster than the new world. The old world faces a daunting demographic challenge. This year's expansion of the European Union from 15 to 25 countries increases its population from 380m to 455m—way ahead of America's 295m. Yet by 2050, the United States will have almost caught up: if forecasts prove correct, there will be 420m Americans, compared with 430m Europeans.

The main reason is that European women have fewer children. In both America and Europe, the post-war baby boom gave way to a bust in the 1970s, and fertility fell below the replacement rate of just over two per woman. But American birth rates have since recovered to replacement level, while the birth rate is just 1.5 in the EU; in Germany, Spain and Italy it is only 1.3 (see chart 1).



Populations age when people live longer and have fewer children. Life expectancy is rising at roughly the same pace in most rich countries—although not in Russia (see article). So it is low fertility that explains why Europe's population is ageing faster than America's. In Germany, the median age will rise from 40 in 2000 to 47 by 2050; in Italy, it will reach 50 as early as 2025. In America, by contrast, it will rise only from 35 in 2000 to 40 in 2050.

Europe's rapid ageing will inflict economic pain. For a start, there will be a big decline in the number of workers. In Italy, for example, the working-age population will shrink by 20% between 2005 and 2035, and a further 15% by 2050. Unless there are offsetting changes in employment rates and productivity, falling numbers of workers will drag down economic growth. Adverse demographics mean that Europe's growth will be half a percentage point lower in 2050 than now, according to estimates in this week's IMF *World Economic Outlook*.

Even as numbers of workers fall, the numbers dependent on them will rise. In Italy, the population aged 65 and over will jump by 44% between 2005 and 2050. Combine that with a decline of over 30% in the working-age population, and the result will be a spectacular jump in the dependency ratio, from 32% in 2005 to 67% by 2050. In France, even though fertility has been higher, the dependency ratio will still jump, from 28% to 51% over the same period (see chart 2).

This soaring elderly dependency ratio will test European budgets to the limit. Looming ahead is a big rise in spending not only on pensions but also on health and long-term care. According to the European Commission, adverse demographic change may push up public spending by between five and eight percentage points of GDP (in the EU 15) by 2040. It will be hard to get taxpayers to foot that bill. Most European countries already suffer from too heavy a tax burden, and governments are running into resistance to higher taxes.

As if all this were not enough, the demographic challenge facing Europe may be even greater than most of the projections suggest. Population forecasters have been caught on the hop by unexpectedly big improvements in longevity. Medical breakthroughs may continue to raise life expectancy beyond the levels built into population forecasts.

What can be done? One response is to try to alter the demographics by encouraging immigration of younger workers. But immigration on the scale needed to stop dependency ratios from rising would be politically unimaginable. Germany, for example, would need to take in an average of 3.6m immigrants a year between 2000 and 2050, according to UN estimates.

An alternative strategy is to try to raise birth rates. In the past few years fertility has risen a little in Italy and Spain. Recent attempts to encourage more births by increasing financial support for parents seem to have been quite successful in France and Estonia. Whether this approach would work in the longer term is less certain. The effect is often to change the timing of child-bearing, rather than the number of births: women bring forward the decision to have children but keep to the number they originally planned.

Birth rates are now especially low in Mediterranean countries where relatively few women work; and a lot higher in Scandinavia, where most women work. Scandinavian countries appear to have found ways, such as enhanced child-care facilities, to make it easier for women to reconcile work with raising children. But such measures assume that women are otherwise being foiled in their desire, on average, to have a family of two. Awkwardly, recent evidence from Germany suggests that women may actually want fewer children than the two-child norm.

All this suggests that population ageing, although a demographic problem, requires an economic rather than a demographic solution. Faster productivity growth would help, but it would be foolish to bank on it. Indeed growth in output per worker may well fall in ageing economies, given the link between innovation and youth. Entrepreneurship tends to be stronger in more youthful populations, says Sylvester Schieber, research director at Watson Wyatt, an actuarial firm.

That leaves two possible economic remedies. The first is to push more of the working-age population into jobs. At the Lisbon summit in 2000, EU leaders set themselves targets for 2010 of reaching an overall employment rate of 70%, and of 50% for 55-64-year-olds. Last year, these rates had risen to 65% and 42% respectively, still short of the Lisbon objectives, let alone of America's rates of 71% and 60%. Raising employment rates is desirable on competitiveness grounds, as well as in response to ageing.

The second remedy would be to increase the size of the working-age population by raising the retirement age. Since Europeans tend to retire before the official state-pension age—in Germany, for example, at 60 rather than 65—there is plenty of scope for this. But proposals to raise the retirement age are deeply unpopular. German politicians were swift to distance themselves from a recommendation by a commission last year that the retirement age should be raised to 67.

These economic remedies are hard, but also vital. Europe still has much work to do to make the labour-market and pension reforms that are needed to counter the adverse effects of its ageing population.

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Russian demography

Death wish

Sep 30th 2004 | MOSCOW
From The Economist print edition

Russia appears to be committing suicide

IN KEEPING with its propensity to extremes, whereas western Europe has a demographic problem, Russia faces a catastrophe. Its population has fallen by around 3.5m since the break-up of the Soviet Union. Such a slump normally results from mass emigration or war, but Russia has been largely peaceful and a net importer of people. The cause is starker: around 10m more deaths than births since the end of communism.

Russia's birth rate dived at the start of the 1990s. It has since stabilised. But widespread infertility, caused in part by the over-use of abortion and in part by sexually transmitted diseases, will help to make a bounceback unlikely. Many rich countries have comparably low birth rates, though; it is Russia's death rate that is beyond compare. It rocketed in the early 1990s; subsided between 1994 and 1998 “from the catastrophic to the merely gruesome”, as Nick Eberstadt of the American Enterprise Institute in Washington, DC, puts it; but has since exploded again. Male life expectancy is lower than it was 40 years ago. Fewer than half of 16-year-old Russian boys will reach 60.

Poverty is only part of the explanation. Russian men are dying earlier than in previous times of comparable hardship, and also earlier than other, even poorer people elsewhere, including in former Soviet states. A wanton disregard for their own health is a big factor—especially their high regard for vodka. Russians are among the heaviest drinkers in the world; but it is above all what they drink, and how (mostly in binges), that explains their susceptibility to heart disease, industrial and traffic accidents, and murder and suicide. A Russian man is around ten times as likely to die a violent or accidental death as a British man. But alcoholism is itself just a symptom of the long, dark night of the Russian soul ushered in by the disorienting collapse of communism.

As Mr Eberstadt notes, in so far as Vladimir Putin's government pays heed to the problem (aside from exhortatory footage of the president's judo bouts), it mainly concerns itself with fertility. The Duma is waging a proxy battle with the beer industry: a ban on drinking beer in the streets, a habit of many Muscovites on their way home from work (and of some on their way in), looks imminent. Yet shop-bought vodka remains a bargain, to say nothing of the caustic moonshine that is widely drunk.

How low could Russia's population go? Perhaps to 100m by 2050, or less if the country continues to neglect its AIDS problem. Tuberculosis is rife. Russia's suicidal bent could eventually threaten its disintegration, if its vast, depopulated territory became ungovernable.

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Greece and the euro

Reality check

Sep 30th 2004 | ATHENS
From The Economist print edition

The post-Olympic glow fades amid a new budget squabble

IT WAS a sad end to Greece's sporting summer. Seven children were killed when a bus taking them to watch the Paralympics in Athens overturned after a collision with a lorry. The closing ceremony for the world's biggest sporting event for disabled competitors was blighted: traffic accidents caused many Paralympic athletes' disabilities. It was the more poignant given the success of the Olympics in August.

Greece's credibility as a modern state, capable of organising a world-class event, soared after the Olympics. Costas Karamanlis, the prime minister whose centre-right New Democracy party defeated the Socialists in March's election, basked in the afterglow. All too briefly. This week's crash, similar to one two years ago, underlined how far Greece lags the rest of Europe. The north-south highway, where both accidents took place, has been improved thanks to EU money, but it is not up to European standards. Checks for roadworthiness are rare in Greece's trucking industry, which is dominated by one-man, one-vehicle businesses.

The government's budget numbers are causing even more embarrassment. A final bill for the Olympics—budgeted at €4.6 billion ($5.6 billion) but now thought to have cost over €7.5 billion—is still being totted up. But it is clear that the budget deficit for 2004 will reach about 5.3% of GDP, well above the supposed 3% ceiling for euro members. George Alogoskoufis, the finance minister, says the deficit can be cut next year to 2.8%. But he will have a hard time convincing anybody that Greece can get below the ceiling in just one year.

That is partly because Mr Alogoskoufis has already shot Greece's fiscal credibility to pieces, by reviewing the budget-deficit numbers for the previous three years. His aim, he says, was to straighten out the public finances and improve transparency. Yet the extent of his upward revisions, which pushed the deficits from below 2% to over 4% of GDP, well above the 3% ceiling, has caused consternation. It has also led rating agencies to put Greece on warning for a possible credit downgrade.

Joaquín Almunia, the EU monetary commissioner, has ordered an investigation into Greece's 1998 and 1999 figures, which were used as the benchmark for its euro entry in 2001. There is some talk in Brussels of suspending EU grants to Greece. But Yannos Papantoniou, the Socialist finance minister who oversaw the country's preparations to join the single currency, is outraged. He says Mr Alogoskoufis has breached the EU's own guidelines so as to make the Socialists look bad and to help the New Democracy government to keep below 3%.

At issue are defence outlays that account for most of the increase in the deficit in Mr Alogoskoufis's review. The Socialists splurged on a $10 billion modernisation of the armed forces at the end of the 1990s, but there was no sign of this in the national accounts. Mr Papantoniou says the government acted under guidelines from Eurostat, the EU's statistical arm, allowing the amortisation of military purchases after equipment has been delivered and certified as being in working order. The equipment payments were to appear in the budget between 2005 and 2007—until Mr Alogoskoufis decided differently.

This Greek quarrel has ramifications for would-be euro members from central Europe, most of which have deficits far above 3%. Already the gutting of the sanctions under the euro-area's stability and growth pact had given them cheer. Now they have seen yet another instance of a country apparently fudging its numbers to qualify—after such big countries as France and Italy resorted to one-off measures to the same end. Do not be surprised if central European countries, like some exemplars in western Europe, miraculously start to report deficits of 2.9% of GDP just when they are seeking to join.

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Ireland's government

Bertie's bolster

Sep 30th 2004 | DUBLIN
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A reshuffle meant to boost the government's support

IT HAS been a good week for Bertie Ahern, the Irish taoiseach (prime minister). On September 29th he announced a long-awaited cabinet reshuffle. And two days later his former colleague in the Fianna Fail party, Mary McAleese, looked certain to be re-elected as Ireland's president, after opposition parties failed to find a candidate.

The reshuffle is intended to revive the government's flagging popularity, by changing ministers, but without changing policies too much. It saw all but three of the 14 cabinet ministers switch their responsibilities. Mr Ahern's hope seemed to be to give his centre-right coalition a less harsh, and more caring, public image.

These changes came three months after Fianna Fail, which heads the coalition, suffered its biggest electoral reversal in decades in local and European elections. The finance minister, Charlie McCreevy, became the scapegoat for the party's mid-term setback. Somewhat reluctantly, he accepted the job of European commissioner in charge of the single market. As expected, his replacement is Brian Cowen, previously foreign minister. The new foreign minister is Dermot Ahern (no relation), formerly communications minister. Mr Cowen's move leaves him the clear favourite to become the taoiseach's successor as Fianna Fail leader.

The government's main challenge has been to regain the public trust that it lost after its re-election in 2002. Mr McCreevy then broke his pre-election pledge neither to raise taxes nor to cut spending. Instead he introduced “stealth” tax increases and tough spending curbs. A disillusioned public felt cheated, and last June took revenge on Fianna Fail at the ballot box.

In fact Mr McCreevy is leaving his successor a remarkable legacy: an economy in fine fettle. The latest official forecasts suggest that the economy will grow by some 4.2% this year. Unemployment will average only 4.5%. And the budget deficit will be a manageable 0.4% of GDP. The healthy state of the public finances leaves Mr Cowen the scope to bring in tax cuts for the low-paid, as a step towards regaining public support for the government.

The big surprise of the reshuffle, however, concerned the tanaiste (deputy prime minister), Mary Harney, who is leader of the free-market Progressive Democrats, Fianna Fail's coalition partner. She is to swap her job as minister for enterprise for the daunting challenge of health, a graveyard of political reputations. This leaves the Progressive Democrats without an economic department, and thus with less influence in government. And as Ms Harney may be minded to try what nobody else has managed, to force structural reforms on Ireland's inefficient health service, her move could yet test the cohesion of Mr Ahern's new-look cabinet.

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Central Europe's economies

Cheap allure

Sep 30th 2004 | KRYNICA, POLAND
From The Economist print edition

Low labour costs matter more than low corporate taxes in central Europe

THE European Union's new members from central Europe are bristling at pressure from France and Germany to raise their corporate-tax rates or risk losing EU subsidies. The French and Germans fear that competition from the east will force them to cut their own tax rates, or lose jobs and investment. Nicolas Sarkozy, the French finance minister, has declared that, if the new members are “rich enough” to forgo high taxes, they can hardly ask the EU for development funds.

“Completely unacceptable,” retorts Tibor Draskovics, Hungary's finance minister, defending his country's right to set corporate tax at a flat 16%, just under half the French rate. In Poland and Slovakia, the corporate-tax rate is 19%, half the effective rate in Germany. Estonia levies no tax at all on reinvested profits. At least the central Europeans can relish one aspect of this row: more foreign investors have learnt about their low corporate taxes.

They are less keen to own that their other taxes are high—though this would be a good riposte to Mr Sarkozy. Hungary's 25% standard rate for VAT is nine points above Germany's. Poland's top 40% income-tax rate bites at €16,200 ($20,000) a year, whereas Britons earn more than twice as much before hitting the 40% band. Government shares of national income still tend to be large: public spending in Poland, Hungary and the Czech Republic takes 45-50% of GDP. Overall, indeed, the central Europeans tax more, not less, than most economists think they should.

They are also bad at balancing their books. Hungary has admitted that its budget deficit last year breached 6% of GDP; Poland is expecting a deficit of 6% this year. But higher corporate-tax rates would do little to close fiscal gaps. Nor, *pace* Mr Sarkozy, would they stop investment and jobs migrating from western to central Europe. For the big attraction of central Europe would remain: its low labour costs.

According to a report by Kevin Waddell of the Boston Consulting Group, presented at last month's Polish Economic Forum in Krynica, labour costs are between five and 12 times lower in central Europe than in Germany. Yet productivity in central European factories matches western Europe's at comparable levels of capital investment and technology. A maker of car parts in Germany could save 30% by moving production to Poland. One moving from Spain could save 24%. For many goods aimed at European markets, central Europe is a cheaper manufacturing base than China, thanks partly to lower shipping costs, says Mr Waddell.

The puzzle is why more foreign firms are not flocking in. One complaint is that small companies still feel uneasy about central Europe's business environment. They worry that governments and regulations change too often, and they find public agencies inefficient and unresponsive. Even big investors hit snags. Hyundai of South Korea recently delayed construction of a car plant in Slovakia, because the government had announced the deal before the site was acquired and local landowners were holding out for sky-high prices.

But if central Europeans can learn from such mistakes, they should prosper. The Boston Consulting Group figures suggest that many foreign companies, perhaps dazzled by China, have underestimated the merits of central Europe. Even if EU pressure led some countries to add a few points on corporate taxes, that would not reduce their fundamental appeal.

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Arctic Norway

The big chill

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A place where Russians starve amid Norwegian plenty

A GIANT bust of Lenin lords it over Barentsburg, an 800-strong settlement in Svalbard. The bust and the Soviet-era murals and street signs leave no doubt that this is a Russian place. Yet Barentsburg, which clings precariously to an arctic mountain, belongs to Norway, not Russia.

Barentsburg owes its existence to the 1919 Versailles conference, which settled a dispute by handing Norway sovereignty over Svalbard but giving other countries the right to establish settlements. Only Russia took this up. Barentsburg is ostensibly for mining. But although there is plenty of coal, the Russians have never turned a profit. Its real purpose is strategic. In the cold war, Svalbard was one of the few places where east and west had to co-exist.

The cold war has thawed, even in Svalbard; yet relations remain frosty. The main town, Longyearbyen, is relatively vibrant. Its 1,750 residents, mostly Norwegians, enjoy a range of shops, restaurants and night clubs. Everything can be had, from wide-screen televisions to extra-virgin olive oil. Tourists are lured by polar-bear trips into the wild interior—Svalbard has twice as many polar bears as people. In short, Longyearbyen is fast becoming an adventure playground for wealthy Norwegians.

In Barentsburg, a short boat ride away, life is very different. There is no double glazing. The miners, most of whom came from Ukraine, put plastic sheets over their windows to keep out the cold—temperatures can dip below -45°C. Living conditions have deteriorated since the collapse of the Soviet Union. Cash from Moscow has dried up; cows that supplied fresh milk have been slaughtered; rotten food caused an outbreak of food poisoning this summer. The miners are angry and muttering mutiny: one has been battered to death.

Norway has an admirable record of humanitarian aid. Yet on Svalbard, officials seem indifferent. Odd Olsen Ingero, the governor of Svalbard, washes his hands of Barentsburg by saying the miners are there by their own choice. “This is a Russian town on Norwegian territory. They are not Norwegian citizens.”

Others see things differently. Per Buxrud, a grocer from southern Norway, got a huge response when he

organised a container of emergency relief. His shipment of toys, hospital supplies, warm clothing and fresh food was welcomed by the miners. Geir Kristian Svendsen, another relief organiser, is ashamed that such poverty is tolerated on Norwegian territory. “Prisoners in all Nordic countries are like kings compared with these people,” he says.

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Charlemagne

How terrorism trumped federalism

Sep 30th 2004
From The Economist print edition

Why Europe became serious about Turkey

Get article background

THE suspense is mounting. Next week the European Commission will issue its opinion on Turkey's fitness to join the European Union. That opinion will be debated at a European summit in December; the summit could, in turn, decide to open membership talks a few months later. If the negotiations go really well—why, it could take a mere decade before something actually happens in the real world, and Turkey joins the EU.

It is easy to mock. In fact, for all the painstaking nature of the process, the EU's decisions in the coming weeks about Turkey will alter the future of the continent. Partisans of Turkish membership believe passionately that saying yes to a large Muslim state that longs to join is critical to avoiding a “clash of civilisations” between Islam and the West. Opponents believe just as strongly that it would be a profound error, which could destroy the EU and even feed political extremism in western Europe.

The EU's tried and trusted method is to drain the drama from such decisions by proceeding through a series of small steps, making it almost impossible to know when the line has actually been crossed. Some argue that Turkey's ultimate membership was decided as long ago as 1963, when the prospect of joining was first dangled before the Turks. Others say the critical moment came in 1999, when an EU summit proclaimed that Turkey was “destined to join the Union”. Still others think that the line has not yet been crossed, but that it will be once the commission recommends that membership talks should begin. No country that has begun negotiations has ever failed to complete them (though Norway's voters later rejected entry). But those seeking to calm anxieties about such a large, poor and Muslim country joining the EU assert that no final decisions are being taken this year. And some—including two senior French ministers only this week—are suggesting that France, and perhaps others, may hold referendums on whether to admit Turkey.

This step-by-step approach to dealing with such a sensitive matter as Turkish membership can make it seem as though Europe's leaders are avoiding considering the big issues by hiding behind a bureaucratic process. But that would be unfair. If, as expected, European leaders do press ahead with Turkey's

application, their decision will reflect a profound reappraisal by leading politicians of the very purpose of their Union. That reappraisal is above all a reaction to September 11th.

The change in thinking of Joschka Fischer, the German foreign minister, is particularly significant. Until recently Mr Fischer was the hero of European federalists. In a speech in Berlin in 2000, he laid out a vision of political union for Europe, led by an “avant-garde” of countries committed to federalism. But earlier this year, Mr Fischer signalled that he had rethought, and now felt that enlarging the EU to include Turkey was a higher priority than building a highly integrated “core Europe”. As he told the *Berliner Zeitung*, “I was previously one of those people who were 51% in favour of Turkey's accession and 49% beset by doubts. I have fundamentally changed my position following the attacks of September 11th. Since then it has become ever clearer that European integration also has a strategic dimension.”

Speaking to journalists in Berlin recently, Otto Schily, Germany's interior minister, spelled out this argument, saying that admitting Turkey to the European Union would “show the world that it is possible for Muslims and the West to live together on the basis of the values of the enlightenment and the UN charter of human rights.” On the other hand, rebuffing Turkey could destabilise the country, with potentially dire consequences: “maybe Turkey would become an Islamist state, like Iran.”

Many traditional federalists are horrified by this shift in thinking in Germany. They fear that, as Sylvie Goulard, a professor at Sciences-Po in Paris puts it, admitting Turkey into the EU will mean abandoning the dream of political union and turning the EU into a “kind of regional UN”. Some suspect that Tony Blair or, worse still, George Bush are pushing Turkish membership precisely because they want the EU to revert to being little more than a glorified free-trade area.

The immigration card

For many Europeans the debate about Turkey does not ultimately revolve around federalism, but rather around the even trickier subject of immigration. Citizens of the EU enjoy freedom to move from one country to another. In Turkey's case that freedom would be delayed through the imposition of a transition period, but it could not be denied forever. The most heated opposition to Turkish membership is coming from countries like Austria, France and the Netherlands, which already have substantial Muslim populations and also far-right and populist parties that have surged on the back of opposition to immigration. The two European commissioners leading the fight against a positive opinion on Turkey are Dutch and Austrian. Frits Bolkestein, the Dutch commissioner, has argued that uncontrolled Muslim immigration into Europe could mean that the defeat of the Turks at the gates of Vienna in 1683 was in vain. In France, the ruling UMP party has come out against Turkish membership, putting itself at odds with President Jacques Chirac himself.

Might all this be enough to stop Turkey's membership talks? Probably not. The combination of a positive opinion from the commission, plus support from the leaders of Britain, France, Germany and Italy, is a powerful one. But the assumption that a decision to open negotiations makes the eventual admission of Turkey inevitable may be wrong. That was how things worked in the past. But a new and unpredictable element has entered the politics of Europe: a growing tendency to submit fundamental decisions to referendums. The Turkish accession train will roll forward next week, and probably next year too. But the chances of voters somewhere eventually pulling the emergency brake are increasing.

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Iraq

The damage Iraq has done him

Sep 30th 2004
From The Economist print edition

Tony Blair's party lets him off the hook about Iraq, but the country doesn't

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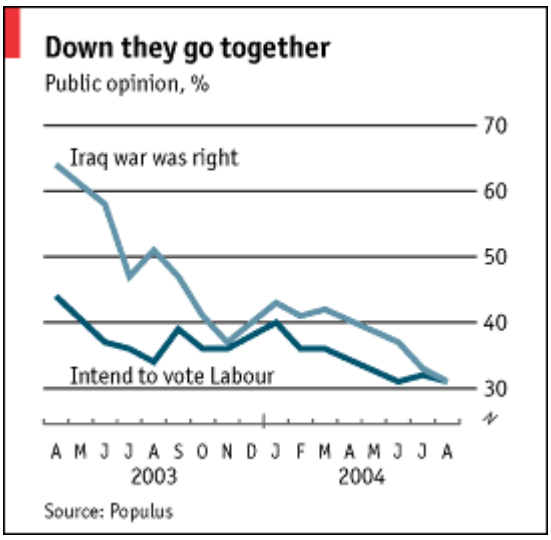
FEW of those at the Labour Party conference this week wanted to talk about Iraq, but there wasn't much choice. The plight of the British hostage, Ken Bigley, hung over proceedings—as, presumably, his captors intended—especially after he denounced Tony Blair in a video screened on the al-Jazeera TV channel.

But the anger that many in the Labour Party had felt towards Mr Blair over what they see as "his war" has settled into resignation. The sole anti-war heckler to interrupt Mr Blair's speech was bundled out swiftly, and the debate on a date for withdrawal from Iraq, which the leadership had tried to avoid, was a low-key affair.



Labour now sees Iraq as a burden it has to live with. It's bad for Mr Blair, so it's bad for the party, and there isn't any obvious way of making it better. The not-quite apology in his conference speech—while refusing to say sorry for going to war, he expressed regret for intelligence failures—will not have done him much good. Nothing he says can satisfy his critics: only a happier outcome in Iraq than currently seems probable will answer them.

Not so long ago, Labour hoped that Iraq had done its worst, because people had made their minds up about the war. That notion now looks shaky. As support for the war has slid over the past 18 months, so has support for Labour (see chart). If things get worse still in Iraq between now and May 5th, when the next general election is expected, things could get worse still for the government.

Those who continue to believe that the war was right are barely a third of the electorate—the same number who say they would vote Labour. About 70% of those Labour voters still support Mr Blair on the war. But the party's private polling suggests that up to 3m of the 10.7m people who voted Labour in 2001 may switch to third parties (mainly to the Liberal Democrats), or just stay at home, because of the way the war has changed their feelings about the government.

So Labour's earlier certainty of winning the historic triumph of a third successive term is dented. It still seems like a party comfortable with and accustomed to power, but suddenly just a little less sure of its

future. That's mainly thanks to the growing strength of support for the anti-war Liberal Democrats.

Nine months before the last election they were polling in the mid-to-high teens. Now, roughly the same time before the likely date of the next election, they are in the low-to-mid 20s. While support for the Conservatives has dropped from the mid-30s to the low-30s since Michael Howard became leader 11 months ago, the Lib Dems have surged. No wonder their leader, Charles Kennedy, ended a confident conference last week by demanding that the election should be a referendum on the Iraq war.

In Britain's first-past-the-post voting system, the impact of a strong push by a third party is impossible to predict. Depending on what happens in marginal constituencies, its effect can vary sharply. The Lib Dems could win another 20 or 30 seats (mostly from the Tories) to add to the 55 they already hold. But the breakdown of the informal anti-Conservative tactical voting that has characterised the past two elections could help the Tories win back seats lost to Labour. Or, as in 1983, when they won 25% of the vote and only 23 seats, Lib Dem votes may stack up everywhere to little effect.

For Labour, that means that instead of cruising to another three-figure overall majority, the party may win the kind of half-hearted mandate that so undermined the Tory government of 1992-97. That wretched outfit tore itself apart over Europe; there would be strains of a different kind on a weak Labour government. How long would Mr Blair carry on if he and “his war” were seen as responsible?

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Conservative Party

It's tough being a Tory

Sep 30th 2004
From The Economist print edition

What people say they want the Conservative Party to be

Get article background

HOW can the Conservatives change from a party that just holds on to votes to one that goes out and wins them? As Tories gather in Bournemouth for Michael Howard's first conference as party leader, many of them think that the answer is simple. Over in Bristol, the UK Independence Party (UKIP), which wants Britain to pull out of the European Union (EU), will also be holding a conference. There, the message that foreigners are only good for trading with will be clear and loud. Surely, Conservatives wonder, we should be tougher on Europe and foreigners too?

Our *Economist*/YouGov poll shows why they think they are right. More than a quarter of voters say they would be more likely to vote Conservative if the party committed itself to withdrawal from the EU (see chart). And 44% say they would be more likely to vote Tory if the party took a harder line on immigration. If winning an election was like baking a cake, all the party would need to do is add those two ingredients and watch its vote rise steadily.

But the Tories are in more trouble than this quick fix suggests. Voters don't identify with the party and are not attracted to Mr Howard. Though they have sometimes harried the government effectively, the Conservatives have failed in an opposition party's other job, namely to charm voters by using the freedom that not being in power brings. After seven years of a government that is now widely disliked, 60% still say that the Conservatives do not understand their needs. Mr Howard has not yet found a way of talking to them.

Mr Howard's leadership may be part of the problem, however. Female voters seem particularly unimpressed by him. Only 7% of women say that having Mr Howard as leader makes them more likely to vote Conservative, compared with 13% of men. The other front-runners don't do much better: 33% of women say they would rather have someone nameless and younger, compared with 29% of men who feel the same way. This antipathy is particularly bad news for the Tories, since the party is normally better supported by women than by men.

At last year's conference, gloom about the party's prospects was lightened by the feeling that Iain Duncan Smith, the party's then leader, would soon by replaced by someone who could unite the Tories and make them loved and successful. Mr Howard has managed to save the party from itself. But if he doesn't begin to show how he will rescue the party from the public, Mr Howard's first conference as party leader could also be his last.

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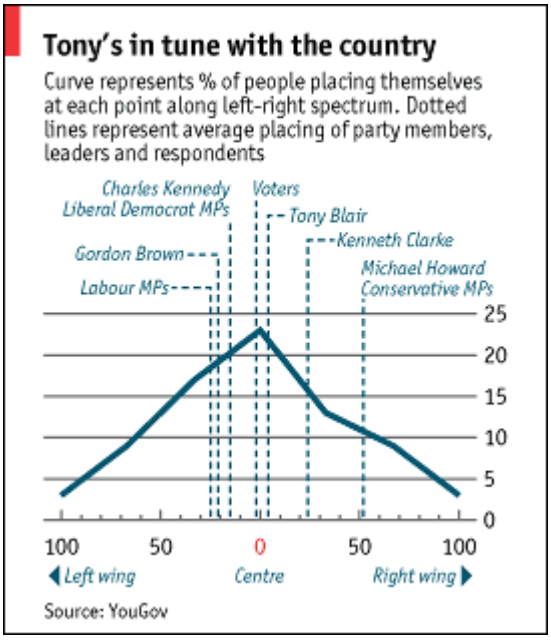
The political spectrum

Dead centre

Sep 30th 2004
From The Economist print edition

Meet Tony Blair, the most average man in politics



ONE of the most memorable soundbites of Tony Blair's seven years in office came right at the start of his premiership. He was, he said, “a pretty regular sort of guy”. Exactly how regular is now clear: an opinion poll shows that people see him as the perfect moderate.

The poll, carried out by YouGov for the *Daily Telegraph* newspaper, asked people to rate themselves on a left-right axis, and to make the same judgment about several well-known politicians. The results confirm much of the received wisdom in British politics. Mr Blair is seen as the centrist face of a party that remains fairly socialist. Gordon Brown, Labour's leader-in-waiting, is much further to the left, as is the rest of the party. Charles Kennedy, the Liberal Democrat leader, occupies a halfway point between Mr Blair and Mr Brown.

More striking are voters' perceptions of Michael Howard and the Conservatives, who are seen as easily the most extreme of the major political parties. With the average Briton placing himself a smidgen to the left of centre, this does not bode well for their chances at the election, or for Mr Howard's job.

The lesson of New Labour has been that elections are won in the centre, not on the fringes. But Mr Blair is not quite *exactly* average: he polls slightly to the right of the typical voter. Out of step with his party and with Mr Brown gunning for his job, Mr Blair might therefore consider deploying his electoral magic on the Tory side of the House. After all, he is justly famous for making a spent political party electable again after endless years in opposition. If he could perform that trick not once, but twice, his place in history would be assured.

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Muslims and hostages

Pleading for sympathy

Sep 30th 2004
From The Economist print edition

British Muslims try to unite over a hostage crisis

"HE'S a man from here, a member of the family, and we're all hoping and praying that with God's help, he will be freed." In the folksy language of a port community that prides itself on an old-fashioned sort of togetherness, a councillor voices the sentiments of almost every Liverpudlian about Ken Bigley, a local man held hostage in Iraq. And so far, at least, nobody has made Mohamed Ali, a Yemen-born social worker, feel uncomfortable about the fact he is the only Muslim member of the municipal authority.

In a city long dominated by rival brands of Christianity, the cause of freeing Mr Bigley has been taken up with equal fervour by mosques, churches and every other religious faith. There is something so ordinary about the 62-year-old contract worker—who might be anyone's wayward great-uncle—that his televised pleas, and those of his octogenarian mother, have triggered powerful emotions. Those emotions may yet turn ugly: to judge by the thousands of messages received by Muslim organisations, the potential exists for a strong anti-Islamic backlash if Mr Bigley meets the same grisly end as two Americans kidnapped along with him.

Partly but not only for that reason, the Bigley case has made British Muslims acutely conscious of pressure to win their spurs as loyal and useful citizens. Faced with the familiar taunt—are you Muslims first, or British first?—the wiser figures in British Islam saw an imperative to prove that this is not a real question. That was one motive, at least, for a brief trip to Iraq by two scholars of Islam, made at the behest of the Muslim Council of Britain, a broad-based umbrella organisation.

The envoys—Musharraf Hussein, an imam from Nottingham, and Daud Abdullah, a London-based academic—found themselves conducting a balancing act. On the one hand, they assured their Baghdad interlocutors—who included the Islamic Party of Iraq and some unspecified "tribal and religious leaders"—that they deplored Anglo-American policy and its civilian victims; on the other, they heeded the British embassy which urged them to keep the trip short for security reasons.

The envoys brought back two messages: that freeing Mr Bigley would be "much easier" if America stopped bombing the city of Fallujah; and also—perhaps more realistically—that it would help if some third party, such as the Red Crescent, could certify that there were no female prisoners in the British-held sector of Iraq.

Elsewhere in British Islam, most leaders were anxious to help free Mr Bigley and play down intra-Muslim jealousies. The Muslim Association of Britain—a constituent member of the MCB, but more radical than its parent—issued a call through al-Jazeera's satellite television channel for the Liverpudlian's unconditional release. Similar calls were heard from even more radical quarters. Yasser al-Sirri, an Egyptian-born Islamist who has resisted efforts to extradite him to America, made a detailed appeal, based on *sharia* law, for Mr Bigley's freedom.

But any hopes that the Bigley case will bring Britain's Muslims together—with one another and with the rest of British society—should be seen in the light of what's been happening in France. A month ago, all the leading factions in French Islam put their bitter squabbles aside in order to organise a mission to Baghdad and plead for the freedom of two French newsmen. Since then the squabbles have reopened, and the newsmen have still not been freed.

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Parents and children

Family values

Sep 30th 2004
From The Economist print edition

Rich kids have little time for their elderly parents. The ingratitude!

AFP

You never call

WHY was King Lear treated so cruelly by his daughters? Until recently, most of the answers have come from scholars with scant knowledge of economic theory. Fortunately, John Ermisch, an Essex economist, is working to remedy this deficiency. His research proves what many parents have long suspected—that increased wealth goes along with filial ingratitude.

Using data from the British Household Panel Survey, Mr Ermisch shows that affluent parents are slightly more likely to supply offspring with money and help with child-rearing than poor parents. But success seems to have precisely the opposite effect on children. The mere possession of a university degree makes children 20% less likely to phone their mothers regularly, and more than 50% less likely to pay them a visit.

This is puzzling because self-interested children might be expected to behave in precisely the opposite way. Most wealthy people are descended from wealthy parents, which means they have a lot of patrimony to lose by cutting back on the fawning. “Nothing will come of nothing,” as a pre-retirement and still sane King Lear put it when his youngest daughter dared to withhold her affections.

So why are rich kids such brats? There are two likely explanations. The first is that, as their income rises, the marginal cost of providing services goes up. It simply isn't worth their while to help with the shopping, particularly since affluence tends to increase distances between parents and children. And, since personal contact correlates with telephone contact, they are less likely to phone, too. Out of sight, out of mind.

Another answer comes from an obscure branch of economics known as strategic bequest theory. This predicts that children will provide only enough services to ensure they get a reasonable share of the inheritance. But that point is reached sooner by those who have only one sibling rival, or none at all. Wealthier families, which tend to be smaller, simply fail to ensure the optimum amount of competition.

Given these iron laws, what are parents supposed to do? Good results might be achieved by having more children, or expressing a sudden interest in the local cats' home. But Mr Ermisch is not optimistic. “The only thing they can do is follow their children around,” he says. And don't make King Lear's mistake by handing over the cash first.

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Smoking

Breathe easy

Sep 30th 2004
From The Economist print edition

An outright ban on public smoking looks unlikely, but a fudge is probable

LIKE the Gulf Stream, policies tend to flow eastward across the Atlantic. Smoking bans are the latest example—from New York last year, they reached Ireland in March. And ministers in Britain have been studying the idea for months.

Scottish politicians like the idea: Jack McConnell, the first minister, has spoken in glowing terms about the effects of the ban in Ireland. But British ministers seem uncertain. Five months ago, a spokesman for Alan Milburn, a former health secretary who now heads Labour's election campaign, said “a smoking ban in public places will be with us soon”. Yet the current health minister, John Reid, is ambivalent, saying last week that the “status quo cannot continue”, but by Sunday talking of the need for compromise.

Part of the reason may be the ambiguous scientific evidence. Ministers see restricting smoking as a matter of public health. But officials disagree about the likely effect: England's chief doctor reckons a ban would save £2.2 billion a year in health costs, but the Health and Safety Executive says that evidence linking passive smoking and cancer is inconclusive.

Public opinion is nuanced, too. Support for restrictions in restaurants (87%) and at work (86%) is higher than for pubs (56%). Of those in favour of new rules for pubs, only 33% think smoking should be banned outright. Most favour some combination of smoking and non-smoking areas.

The potential impact on business may also be staying the government's hand. Sales in Irish pubs fell by 16% after the ban. The British Beer and Pub Association says that 75,000 British jobs would be at risk.

Nonsense, say anti-smoke campaigners. They cite a New York report showing that bars and restaurants took on an extra 2,800 staff to cope with increased demand after the ban. But the study includes workers at places like Starbucks and McDonald's that never allowed smoking in the first place. This distorts the results. The New York Nightlife Association reckons that sales in establishments affected by the ban are down about 20%.

In early September, five big British pub companies, representing about 40% of the market, volunteered to set aside 35% of their floor space as smoke-free, rising to 80% by 2009. The companies say this is more than just a ploy to avert prohibition: they believe that the market is heading in that direction anyway as public attitudes to smoking change.

So what might the government do? Most believe it will go for one of two possible fudges. First, it might leave the issue to local authorities. Some councils, such as Liverpool, are keen, but nobody else likes the idea. Anti-smoking groups worry that some would choose not to regulate; pro-smokers oppose any government interference with their vice. Even the pubs think it would be a bad idea: coping with the resulting patchwork of legislation would be an administrative nightmare.

The other option would be a general restriction on smoking in public places, with exemptions or caveats for some sectors. But if smoking really is a public-health issue, it would be odd to exempt some members of the public from the rules.

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Trams

Derailed

Sep 30th 2004 | MANCHESTER
From The Economist print edition

Too much demand in China and too little in Croydon

THOUSANDS of Mancunians have attended demonstrations about a government decision to halt the planned extension of the city's tram system. Trams were a snazzy symbol of Manchester's aspirations for continental modernity when they started running in 1992. The Labour government liked the idea too: in 2000 it said that it wanted 25 more schemes by 2010, on top of existing metros in Tyneside, Manchester, Sheffield, Birmingham and London.

The trouble is that estimated costs soared to £900m from an initial £489m, while the planned subsidy for the next 30 years rose from £150m to £510m. And a recent report from the National Audit Office, a spending watchdog, said that light rail schemes were proving poor value for money. Sheffield's trams expected 22m passengers a year by 2000 but now carry just over 12m. The Croydon tram in south London forecast 26m passengers a year; it now has just under 20m. So even though £220m has already been spent on preparatory work, the government has blocked not only the new Manchester lines but also a £500m scheme in Leeds and a £270m one in Portsmouth.

Opinion in Manchester is outraged—not about the profligacy, but by the loss of prestige. Angie Robinson, chief executive of the Manchester Chamber of Commerce, says that the government has been divided: shortly after the transport secretary, Alistair Darling, blocked the tram project, John Prescott, the deputy prime minister, backed a report on northern regeneration which argued that the tram extension “is critical to unlocking the full economic and social potential of the area”. Local Labour MPs have persuaded Tony Blair to set up a working party to find ways of making the scheme cheaper.

That will be hard. Geoff Inskip, deputy boss of the agency promoting the project, says that about 40% of the cost increase is due to inflation in construction materials, such as steel for rails. That's true for all construction projects: China's economic boom is gobbling raw materials and raising prices. The second problem is that poor performance of existing schemes means that banks now think trams are risky. They are prepared to provide less money and at greater cost in both interest and equity.

Mr Inskip hopes to use new powers to make buses connect with trams rather than compete with them. But that would mean municipal control—and subsidy—for Manchester's presently deregulated bus services. Jim Battle, Manchester City Council's deputy leader, says that without the new tramlines, regeneration schemes costing several hundreds of millions of pounds in east Manchester and outlying towns may fail. But such arguments may raise the risk further in bankers' eyes: they imply that the trams' future fare income depends on jobs as yet uncreated.

Stephen Glaister, a transport economist at Imperial College, London, says that risks like these are what private financing reveals. That's better than letting ambitious local authorities go ahead, leaving risks uncosted and the taxpayer to pick up the tab if things go wrong.

Mr Battle says that the council is pondering how to reduce the risks to private backers so as to make the scheme more attractive. If political pressure means that the government accepts this face-saving compromise, Manchester's council-tax-payers may need to brace themselves.

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Waste

Bin there

Sep 30th 2004
From The Economist print edition

How China is encouraging the British to recycle their waste

IF BRITAIN is going to use its presidency of the G8 next year to lecture about the environment, it may have to hide its rubbish bins. Compared to good Europeans in Germany and the Netherlands, where around half of household waste is recycled, Britain's record stinks. Though the recycling rate has risen recently, it is still below 15%. Even allowing for disparities in the way recycling is counted, Britain is far behind.

This week the government announced a £10m advertising campaign voiced by Eddie Izzard, a cross-dressing comedian, to encourage recycling. This doesn't sound like much given how far behind Britain is. But avid recyclers argue that the habit is a cultural one, like wearing jumpers tied around the neck, that is just more developed in mainland Europe. The adverts, they hope, will make it seem less alien.

Britons have long been able to throw rubbish away cheaply, making recycling more expensive than elsewhere. Over three-quarters of household waste currently ends up in big holes in the ground, compared with 12% in the Netherlands. Britain has plenty of suitable craters, thanks to an almost defunct mining industry and soft but impermeable clay soil.

Now local authorities, who are responsible for collecting rubbish, are being forced to care more. Landfill sites are filling up and the government is committed to a European target of reducing the amount of trash going into them by a quarter of its level in 1995. Recycling is one way to meet that target and so, as is its way, the government has set another one—to increase the rate of recycling to 25% by 2006.

Previous attempts to get people to recycle more have not met with much success, but some councils have been trying new things. Barnet in north London has made recycling compulsory in four wards, with the help of wardens and the threat of a £1,000 fine. Recycling has increased across the borough from 13% a couple of years ago to 20% now. But this sort of thing is expensive. Currently Britain spends around 65-70p per person each week on getting rid of rubbish. That will have to rise to around £1.50 to reach the same level as the best-behaved Europeans, according to the Environmental Services Association, a trade body for waste-disposal companies.

Fortunately, that cost may be heading down a little thanks to increased demand for used materials from Asia. The price of scrap steel has risen from £50 a tonne in 2002 to £120 now. The Iron and Steel Statistics Bureau predicts that exports of scrap steel from Britain will soon rise above £1 billion. The main reason is increased demand from China. Growing Chinese demand also seems to have changed the economics of collecting plastic bottles. Exports of used ethelyne polymers (the biggest category of plastic) to Hong Kong and China increased from £4.6m in 2000 to £7.9m last year.

Some greens worry that the energy used to send a boatload of material for recycling across the world is not justified by savings at the other end. But the containers that arrive from Shanghai filled with shoes and televisions would otherwise go home empty. If more of Britain's waste can be used economically, that's good news.

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Red mercury

Mythed again

Sep 30th 2004
From The Economist print edition

Anti-terrorist police foil an attempt to buy a non-existent substance

HOW bad is trying to buy something that doesn't exist? That's the conundrum posed by this weekend's sting operation in which the *News of the World*, Britain's best-selling Sunday tabloid, set up a group of people who, it says, wanted to buy bomb-making material on behalf of a Saudi backer. After a couple of meetings, the journalists alerted the police and four men were arrested.

But what were they trying to buy? Red mercury, which the *News of the World* said it had available at £300,000 ($540,000) a kilo, is one of the most mystifying substances in the bombmaker's arsenal. A compound of mercury and antimony, supposedly invented by Russia during the cold war, it has been variously touted as a booster for rocket fuel, as a way of unblocking oil wells, as an ingredient in anti-radar paint, and as an extremely powerful liquid explosive ideal for triggering small nuclear bombs.

Here's the twist: most experts say it doesn't exist. Certainly, no sample of red mercury with the properties claimed for it has ever stood up to independent public scrutiny. But there are some lingering doubts. Frank Barnaby, a respected nuclear physicist and weapons expert, says that a version of the compound with some military application may have been developed in the Soviet Union. “You can't dismiss it out of hand—it's such a persistent story,” he says. Another explanation is that red mercury was concocted by western intelligence services as a way of flushing out dealers in dangerous nuclear materials.

But what will happen if the suspects are charged and go to trial? It's hard to see “instigation and preparation of acts of terrorism” being stretched to include plotting to get hold of something that sounds nasty but doesn't actually exist. But it's also hard to see the authorities, who have always poo-poohed red mercury, turning up in court to say that it's real and dangerous after all.

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Bagehot

Back to basics

Sep 30th 2004
From The Economist print edition

Tony Blair is turning his attention from appealing to Tory voters to placating Labour ones

THE prime minister's big speech this week at the Labour Party conference was not vintage Blair. As a rule, Tony Blair uses these occasions to challenge his party to be more, well, Blairite. But this year there was no echo of the hubristic “at our best when at our boldest”; just a list of unobjectionable-sounding policies that promised to make life nicer for lots of people. The evangelical uplift of previous years, when Mr Blair gave the impression that he was on a mission single-handedly to banish poverty and cruelty from the world, was also gone. With Iraq in flames, it would have sounded a bit odd.

Inevitably, the talk afterwards was mostly about the passage on Iraq. Mr Blair spoke frankly about his own fallibility and doubts. The tone was rueful, rather than defiant. Leaders, he said, are required to make difficult judgments: he still believed he had made the right one about Iraq, but others were entitled to think differently. All he asked was that they should understand why he had done what he had done.

But there was not a great deal Mr Blair could do to placate critics of his Iraq policy. Many, if not most, in his party will always be convinced that he made a terrible mistake. Which makes it all the more striking that the party is so eager to forgive him.

The party is not going to make trouble for Mr Blair, because it is still grateful to him for giving it the longest period of uninterrupted power it has ever had. Although the media coverage of Mr Blair's speech focused on Iraq, most of it was devoted to reminding his party how economic stability and steadily increasing public spending had delivered what the government had promised. The “progressive future”, he said—the words, unusually, echoed those which Gordon Brown, the chancellor, had used a day earlier—would permanently consign the Tories to the margins of British politics.

Mr Blair did not spell out how this had been achieved. He joked that Labour was lucky in its opposition. But luck has nothing to do with the plight the Conservatives find themselves in today. Mr Brown can take credit for sound economic management, but it is Mr Blair's political brilliance that has done for the Tories. Thanks to him, they have become a party too big to disappear, but too unpopular to win power.

Mr Blair's method has been never to permit the Tories to have policies that are both distinctive and attractive. If they look like coming up with a theme or an idea that sounds good, Mr Blair promptly appropriates it and recasts it in a New Labourish guise.

The social conservatism of David Blunkett, the home secretary, is not an aberration. Mr Blunkett has forced one shadow home secretary, Oliver Letwin, into unpromising territory (for the Tories) to his left, and another, David Davis, into coming perilously close to playing the race card. Often, however, Mr Blair simply gets there first. For example, he took up the idea of “choice” in public services well before the government actually had the means or the policies to deliver it. The Tories were left trying vainly to explain how their sort of choice was different to the government's variety.

The need to occupy Tory ground has often led Mr Blair to pick fights with his own party. There are signs, however, that he has decided that this strategy may have had its day.

This week, the prime minister was not confronting his party, but rubbing its tummy. He still wants to extend choice, but is now dressing it up in the language of redistribution. The outline he gave of ten policies that would form the basis of next year's manifesto included better state pensions, guaranteed paid holidays for poorer people, affordable child care and help for first-time home buyers. The emphasis was on the practical and the popular, not the contentiously radical.

It's easy to see why. Labour strategists are worried about both the sour mood of the activists and the possibility that much of the party's traditional vote will stay at home or leach to the Liberal Democrats. Robin Cook, a former foreign secretary who resigned from the Cabinet over Iraq, says that he meets people whose fortunes have been transformed by the tax credit designed to boost the incomes of low earners, but who don't realise that they have the government to thank rather than some obscure administrative change at the Inland Revenue. Mr Cook, along with Mr Brown's supporters, blames Mr Blair's reluctance to boast of the government's redistributionist policies for fear of alarming middle-class voters.

Mr Blair, ever alive to electoral danger, now seems to agree. Since the Tories have little chance of reclaiming the political centre ground, it makes sense to lavish attention on the core Labour vote between now and the election.

All together now

If this is right, it means that the squabbling between Blairites and Brownites over the manifesto that has dominated media coverage of the conference may be yesterday's story. In spite of nuanced differences between the speeches Mr Brown and Mr Blair made this week, both men applauded one another with teeth ungritted. And, in contrast to last year, each also paid public tribute to the other—Mr Blair with such warmth that Mr Brown seemed genuinely touched. Nor, despite claims to the contrary, is there any dispute about putting Labour's record of economic competence at the centre of the election message. As Mr Blair made plain, the “forward offer” to the electorate beloved of campaign strategists rests on the continuation of sound economic management.

Mr Blair and Mr Brown will still rub each other up the wrong way and their aides will still, at times, magnify the significance of every slight, real or imagined. The political rivalry is too raw for it to be otherwise. But, at least until the next election, the arguments about policy may be over.

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The dragon and the eagle

Sep 30th 2004
From The Economist print edition

American consumers and Chinese producers have led a global boom. China is creating genuine wealth, but America's binge is based partly on an illusion, says Pam Woodall, our economics editor

OVER the past year the world economy has grown by almost 5%, its fastest pace in two decades. Growth has been powered by two high-octane fuels: America's exceptionally loose monetary policy, which has encouraged consumers to keep spending; and an unprecedented investment boom in China. America and China together accounted for almost half of global growth over the past year. If American consumers and Chinese producers were to retreat at the same time, global growth could slump.

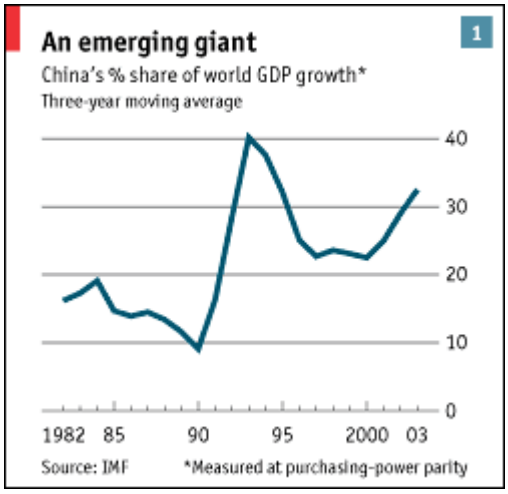
Until the Federal Reserve started to lift interest rates in June, money had been cheaper than ever before, and not just in America: average short-term interest rates in the world's big economies were at their lowest in recorded history. Average real interest rates are still at their lowest since the high-inflation 1970s. By slashing rates to 1% after the stockmarket bubble burst, the Federal Reserve saved America from a deeper recession and the risk of deflation.

But inflation is now rising, so monetary policy needs to be tightened. How will the American economy—indeed, the world economy—fare if interest rates return to more normal levels of perhaps 4-5%? Super-low rates have encouraged consumer behaviour that will look a lot less sensible as interest rates rise. And to make things trickier, crude-oil prices have surged to new heights at the very time that the Fed has started to raise rates. Dearer money and dearer oil have already caused consumers to cut back.

China's breakneck pace of growth also looks unsustainable. In the year to the second quarter its GDP grew by almost 10%. Real fixed investment was increasing at an annual rate of 35% earlier this year; bank lending has been rising too fast, fuelling a property bubble; and inflation has moved above 5%. If China suffers a hard landing, the rest of the world will feel the bump: in the past three years, the country has contributed one-third of the world's growth in real output, measured at purchasing-power parity (see chart 1).

Only a few years ago, the term “the world economy” was used as shorthand for the economies of the developed world; China would at best rate a brief mention. But now it is too big to ignore (see chart 2, below). It was largely thanks to China's robust growth that the world as a whole escaped recession after America's

stockmarket bubble burst in 2000-01. But its recent boom is also responsible for much of the surge in global energy demand that has pushed up oil prices. China's massive purchases of American Treasury bonds explain why the dollar has not fallen further or bond yields risen more sharply—even though America's huge current-account deficit continues to widen. Last but not least, many people blame the sickly state of America's jobs market on imports from China and on outsourcing.



China is home to one in five of the world's people, and has long been the most populous country on earth, but economically it has started to matter only recently. China's GDP already accounts for 13% of world output (at purchasing-power parity), second only to America's. By the end of this year China will probably be the world's third-biggest exporter (after America and Germany). It is also the largest recipient of foreign direct investment as multinationals have moved operations to China to take advantage of its low labour costs and huge domestic market. It is the new workshop of the world, producing two-thirds of all photocopiers, microwave ovens, DVD players and shoes, over half of all digital cameras and around two-fifths of personal computers.

But China is not only a big new producer, it is also a big new market. Its imports grew by 40% last year, and over the past three years it has accounted for one-third of the total increase in world import volumes. China has become a locomotive for the rest of East Asia, accounting for half the total export growth of the other East Asian economies last year. Indeed, exports to China have played a big part in Japan's recent economic recovery. China's demand for commodities has also rocketed, driving up world prices.

If China sneezes

Over the past year, China's policymakers have been trying to cool the economy, and there are signs that they are succeeding. Both investment and bank lending have already slowed quite sharply. But will the economy land gently or with a crash, as it did after the 1993-94 boom? A crash would dent growth in the rest of the world just when the Fed is raising interest rates.

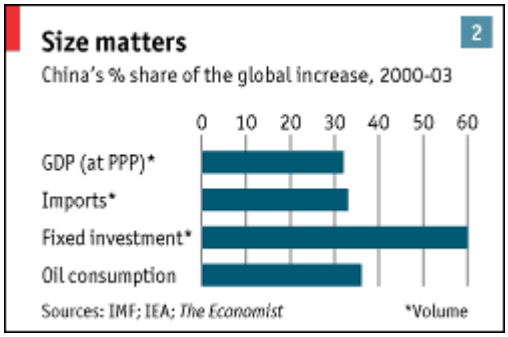
Yet China's boom is itself partly the product of the Fed's super-lax monetary policy. With its currency pegged to the dollar, China has been forced to import America's easy monetary conditions. Its higher interest rates have attracted large inflows of capital that have inflated domestic liquidity, encouraging excessive investment and bank lending in some sectors which could lead to a bust. Fortunately the economy is not as overheated as it was in the early 1990s, when investment, credit and inflation were all growing much faster; and this time the authorities have acted sooner. But even if China can engineer a soft landing (which is generally defined as growth slowing to around 7%), growth in investment and imports of capital equipment and raw materials would slow much more severely, causing some global discomfort.

Some commentators liken China's boom to America's dotcom bubble in the late 1990s; but although investors have clearly got carried away, much of the exuberance about China is rational. The country's recent ups and downs are reminiscent of America's booms and busts during the period of industrialisation in the late 19th century. These did not prevent America becoming the world's economic giant, creating fast-growing markets for European goods. If China continues with its reforms, it will enjoy faster growth than America ever achieved. Within a decade it will probably be the world's largest exporter and importer, and one day it may overtake America as the world's largest economy.

That strikes fear in the heart of many businessmen and workers in rich countries. In America's presidential-election campaign, China has been widely blamed for America's “jobless recovery”; yet faster growth in China should mean faster rather than slower growth elsewhere too. China has a unique combination of a huge population and an economy that is unusually open to the rest of the world, as measured by trade or foreign direct investment. China's catch-up in income and its integration into the world economy could be the single biggest driver of global growth over

coming decades. Indeed, China's boost to global growth could exceed the much-trumpeted gains from the IT revolution.

China's road to prosperity is not without risks. Its economy may well stumble during the next year or so. But its future prospects remain excellent, built on genuine wealth creation as currently underemployed labour is put to productive use. In contrast, American consumers have been living in never-never land, financing their spending by borrowing against illusory gains in wealth.



Not as rich as you think

Economies can get truly richer only through increased productivity growth, either from technological advances or from more efficient production thanks to international trade. Thus China's integration into the world economy genuinely creates wealth. The same cannot be said of all the “wealth” produced by stockmarket or housing bubbles.

In recent years, many people around the world have found it easier to make money from rising asset prices than from working. Roger Bootle, the managing director of Capital Economics, a London consultancy, calls this “money for nothing”. The surge in share prices in the late 1990s boosted the shareholdings of American households by $7 trillion over four years, equivalent to almost two years' income from employment—without requiring any effort. The value of those shares has since fallen, but the drop has been more than offset by soaring house prices. Over the past four years the value of homes in America has increased by more than $5 trillion, making many Americans feel richer and less inclined to save. But much of this new wealth is an illusion.

The first mistake, at the end of the 1990s, was to believe that shares were actually worth their quoted price. The second mistake, today, is to view higher house prices as increased wealth. A rise in share prices can, in theory, reflect expected future gains in profits. The stockmarket boom did reflect some genuine wealth creation in the shape of productivity gains, however exaggerated they may have been. But rising house prices do not represent an increase in wealth for a country as a whole. They merely redistribute wealth to home-owners from non-home-owners who may hope to buy in the future. Nevertheless the illusion of new-found wealth has caused households as a whole to save less and spend and borrow more.

Historically low interest rates have fuelled housing bubbles in America and many other countries around the globe. At some stage prices will fall, obliging consumers to save much more and spend less. The unwinding of America's vast economic imbalances could depress growth there for many years, whereas China's slowdown looks likely to be fairly brief.

Oddly enough, China may be partly to blame for this wealth illusion in rich economies, because central bankers have been slow to grasp the consequences of China's rapid integration into the world economy. By producing goods more cheaply and so helping to hold down inflation and interest rates in rich economies, China may have indirectly encouraged excessive credit creation and asset-price bubbles there. Inflation has remained low, but excess liquidity now flows into the prices of houses and shares rather than the prices of goods and services. And to keep its exchange rate pegged to the dollar, China has been buying vast amounts of American Treasury bonds, which has helped to depress bond yields and mortgage rates, fuelling America's property boom.

This survey will explore the many ways in which China's rapid economic development is affecting the rest of the world, from jobs and growth to oil prices and inflation. The integration of China's 1.3 billion people will be as momentous for the world economy as the Black Death was for 14th-century Europe, but to the opposite effect. The Black Death killed one-third of Europe's population, wages rose and the return on capital and land fell. By contrast, China's integration will bring down the wages of low-skilled workers and the prices of most consumer goods, and raise the global return on capital.

Some central banks, slow to grasp the effect of these structural changes on inflation and monetary policy, have been running overly loose policies that have fuelled unsustainable booms in America and some other economies. In the short term, therefore, China could make growth more volatile, but in the long term it will be a powerful engine of global growth. The Black Death is thought to have originated in China and spread to Europe through trade. This time China will export vitality to the world economy

instead.

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The real Great Leap Forward

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From The Economist print edition

If reforms continue, China's economy could sprint ahead for many more years

“LET China sleep, for when she awakes she will shake the world,” runs Napoleon's famous saying. He was ahead of his time, but now the dragon is certainly stirring. Since 1978, when Deng Xiaoping first set his country on a path of economic reform, its GDP has grown by an average of 9.5% a year, three times the rate in the United States, and faster than in any other economy. The official figures may slightly overstate the growth rate, but China is still likely one day to overtake America and become the world's number one economy.

In fact, China was the largest economy for much of recorded history. Until the 15th century, China had the highest income per head and was the technological leader. But then it suddenly turned its back on the world. Its rulers imposed strict limits on international trade and tightened their control on new technology. Measured by GDP per person it was overtaken by Europe by 1500, but it remained the world's biggest economy for long thereafter. In 1820 it still accounted for 30% of world GDP. However, by 1950, after a century of anarchy, warlordism, foreign suppression, civil war and conflict with Japan, its share of world output had fallen to less than 5% (all figures at purchasing-power parity; see article).

Now China is making up lost ground. Even if its economy slows sharply over the next couple of years, its long-term prospects remain bright. If rich economies want rapid economic growth they have to get it the hard way, by inventing new technology or adopting better management methods. But poor countries, at least in theory, should find it easier to grow fast because they start with low levels of income and capital per worker. With the right policies, they have huge scope to grow rapidly by importing capital, ideas and techniques from developed economies and using rich countries' markets as a springboard for growth. As a latecomer, China does not need to reinvent the wheel, but merely to open its economy to ideas from the rich world—which it has done with gusto.

Most of China's growth over the past quarter-century can be explained by high rates of investment and the movement of workers from subsistence farming, where their marginal productivity is close to zero, to more productive use in industry. But China's growth is not based simply on cheap labour: wages are lower in India and Vietnam. It also has the advantages of good infrastructure, an educated workforce, a high rate of saving available to finance investment and, most important of all, an extremely open economy. China's average tariffs have fallen from 41% in 1992 to 6% after it joined the WTO in December 2001, giving it the lowest tariff protection of any developing country.

Many non-tariff barriers have also been dismantled. Moreover, China has welcomed foreign direct investment, which has bolstered growth by increasing the stock of fixed capital and by providing new technology and management know-how. Joint ventures with foreign firms produce 27% of China's industrial output.

China faces many obstacles to growth: its fragile banking system, the lack of a transparent legal system, corruption, the risk of social and political unrest caused by widening income inequalities or the abuse of human rights, and severe environmental pollution. Yet if reforms continue, there are good reasons to believe that rapid growth can be sustained.

For example, there is still huge scope to increase productivity as workers move from rural occupations into industry. Over 60% of China's population still lives in the countryside, a much higher share than in Japan at the same stage of development. The steady shrinking of the state-owned sector will also boost productivity by ensuring a better use of resources. China's private sector, which now accounts for about half of its GDP, is growing twice as fast as the rest of the economy.

The main constraint on China's growth is its financial system's inability to allocate capital efficiently, with the associated risk of bad loans in the banking system. Some commentators fret that China's inefficient

investment will soon drag down its growth rate, pointing out that China's incremental capital output ratio (ICOR—the increase in annual investment divided by the increase in GDP) has risen in recent years. This suggests that the country is having to plough in more money to generate the same amount of growth—ie, its return on investment has fallen. There certainly has been overinvestment in some sectors, such as cars, steel and property, and inevitably some projects will prove unprofitable. The financial system needs to be reformed to improve investment decisions. But as a measure of the return on investment in China, the ICOR is badly flawed.

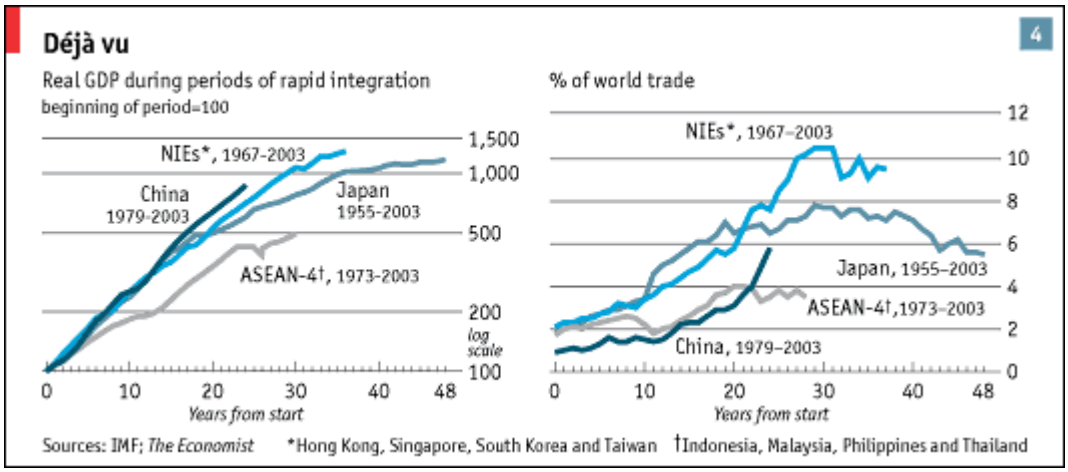
First, Chinese government figures overstate investment; they include purchases of land rather than just showing value added, as GDP does. Second, they are for gross investment, whereas a more meaningful measure would be net investment after depreciation and the writing off of poor-quality capital equipment in state-owned firms. On the basis of net investment, the ICOR has risen more modestly, in line with what happened in other Asian economies during industrialisation.

Lastly, a high level of investment is what you would expect, given China's rapid industrialisation and urbanisation, which requires massive infrastructure investment and residential construction. According to Hong Liang at Goldman Sachs, China's rising ICOR simply shows that the economy is at a stage of development where it needs to become more capital-intensive. In manufacturing, the ICOR has in fact fallen slightly.

The IMF reckons that, so long as structural reforms continue, notably in the banking sector and in state-owned enterprises, China should be able to sustain annual growth of 7-8% for at least another decade. At that pace, China's GDP, measured at PPP, would overtake America's before 2020, although its GDP per head would remain much lower. Measured at market exchange rates, it would take longer to top America's. A study by Goldman Sachs concluded that this might not happen until around 2040, although China could overtake Japan as early as 2016.

This forecast was based on realistic assumptions about the likely slowdown in capital accumulation and productivity growth as well as on demographic forecasts. It predicted a slowdown in China's annual real GDP growth rate to 5.5% for 2010-20, and only 4% after that. It also foresaw that over time China's real exchange rate would appreciate against the dollar in line with its faster productivity growth.

Goldman Sachs's forecast may be too cautious. A study by the IMF compares China's rapid integration into the world economy with similar developments in the past, for example when growth first took off in post-war Japan, and later in the East Asian newly industrialising economies, such as South Korea or Taiwan (see chart 4). China has grown a little faster during the past 25 years than Japan or the East Asian newcomers during their first quarter-century of boom, but these economies then maintained rapid growth for a long time. Despite hiccups along the way, South Korea and Taiwan sustained average growth rates of almost 8% for four decades.



Growth rates inevitably slow as average income rises towards that of developed economies, but China's GDP per person is still well under a third of South Korea's and one-fifth of Japan's, so there is plenty of room to catch up. China's share of world trade is also still lower than that of Japan or the combined trade of the East Asian tigers at a similar stage in their integration process, suggesting that China could continue to maintain rapid export growth for some years. For example, it currently accounts for 13% of all American imports, whereas Japan's share of the American market peaked at 22% in 1986.

Even if China's economic performance so far is not all that exceptional compared with that of its Asian forerunners, the country will almost certainly play a bigger future role in the world economy because of the sheer weight of its population. As China's income per head catches up, its economy will soon dwarf those of its Asian neighbours. How will the awakening dragon affect the rest of the world?

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Economic weight-watching

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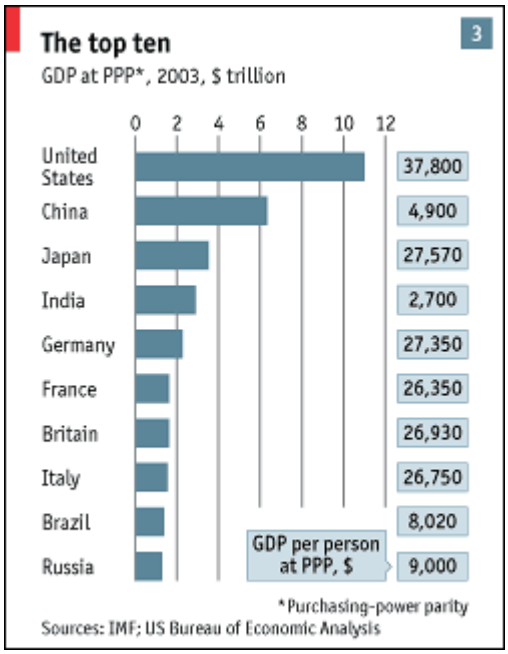
China's economy is larger than it looks

HOW big is China's economy in relation to America's? The answer depends on how you convert the yuan value of China's output into dollars. Converting countries' GDPs into dollars at market exchange rates can be misleading, not least because currencies may be grossly under- or overvalued and can swing wildly. A better method is to use purchasing-power parities (PPP), which take account of differences in the prices of the same goods and services between countries.

Internationally traded goods should in theory cost broadly the same around the world, but prices of non-tradable items, such as housing and labour-intensive services, are generally much lower in emerging economies than in developed ones. A haircut, for instance, is much cheaper in Beijing than in New York. This means that a dollar in China buys a lot more than a dollar in America. PPP corrects for this by valuing goods and services on a like-for-like basis.

Because of lower prices, converting a poor country's GDP into dollars at market exchange rates will significantly understate the true size of its economy as well as its living standards. Measured at market exchange rates, China's GDP accounts for only 4% of global output, making its economy the world's seventh-largest. But using PPP to revalue its output at American prices, China moves into second place behind America, with 13% of world output (see chart 3). Likewise, using GDP converted at market exchange rates, China has accounted for only 17% of the total increase in global real GDP over the past three years; but measured on a PPP basis, it has contributed almost one-third of global GDP growth, much more than America's 13%.



Measures of PPP are admittedly imperfect, but they give a more accurate measure of the relative size of economies than market exchange rates. The IMF has used PPP in its *World Economic Outlook* since 1993. As countries grow richer, the prices of their non-traded products tend to rise, so the gap between the two measures of output narrows.

But PPPs are not appropriate for everything. Trade and capital flows, unlike the bulk of GDP, are actually transacted at market exchange rates, and should be converted into dollars at those rates. PPP is useful in showing how much a country's money is worth in its home market, but it does not measure effective purchasing power across borders. What matters for businesses that trade internationally is China's buying power in current-dollar terms. Even if a Chinese hairdresser has the same domestic purchasing power as an American stylist, his money will stretch to far fewer imports.

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The halo effect

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How China's expansion will affect growth and jobs elsewhere

"WHAT you cannot avoid, welcome," says an old Chinese proverb. The world would be wise to bear it in mind in its dealings with China. The country's global integration will have a bigger impact on the world economy than that of any previous emerging economy. Fortunately, though, it will be mostly a force for good, boosting overall prosperity.

China's ascent will affect the outside world more than Japan's did in its time, not only because of the potential size of its economy but also because of two distinct features. First, for such a big economy it is unusually open to trade and investment. This year the sum of exports and imports of goods and services is likely to reach 75% of China's GDP, far more than in other big countries: in America, Japan, India and Brazil the figure is 30% or less. At its peak, Japan's trade reached only 32% of its GDP. Similarly, the stock of total investment in China by foreign firms is equivalent to 36% of its GDP, compared with 2% in Japan.

The second feature is that Chinese manufacturers have access to an almost unlimited supply of cheap labour. By some estimates, there are almost 200m underemployed workers in rural areas that could move into industry. This surplus labour may take at least two decades to absorb, helping to hold down wages for low-skilled workers (who currently earn less than 50 cents an hour). Japan and South Korea, in contrast, absorbed their rural labour much more quickly. Although average real wages in Chinese manufacturing have increased quite briskly over the past decade, the main beneficiaries have been skilled rather than unskilled workers.

The idea that China may become the world's biggest economy, with an enormous army of cheap workers, fills many in the rich western world with dread. Yet China's combination of rapid growth, vast size and openness could deliver a big boost to incomes outside China as well as at home. Rather like America when it entered the world economy in the late 19th century, China will be giving a huge boost to both global demand and supply.

The prospective stimulus to demand is easy to understand. China is the world's fastest-growing market (see chart 5), and by around 2010 total spending in absolute dollar terms there will probably be increasing faster than in America. Even if average incomes remain low, a growing number of Chinese will enjoy high incomes. If China's real income grows by 8% a year and its income distribution remains unchanged, by 2020 the top 100m households will have an average income equivalent to the current average in western Europe. That will open up a vast market for consumer goods.

More important in the long term will be the supply-side stimulus that China could give to developed economies' growth. This will take several forms:

•**Greater specialisation**. China's development will expand the size of the global market. As Adam Smith pointed out, the bigger the market, the greater the scope for the division of labour. Opening up China should boost global productivity growth by allowing greater specialisation. Initially, China is likely to specialise mainly in relatively low-skilled labour-intensive manufacturing, whereas developed economies will concentrate on activities needing higher skills.

Jobs will be lost in manufacturing in the developed world, but new jobs will be created, largely because

most of the money that China earns from exports is being spent on imports from rich economies. Sustained growth in income and jobs relies on a continuous shift of resources to higher-value industries. A frozen job market with no hiring or firing would be in nobody's interest.

•**Improved terms of trade**. A country can become better off not just by producing more, but through a rise in the price of what it produces relative to the price of what it buys. Another important way in which China will affect the world economy is by changing relative prices. The prices of products that China makes will fall; the prices of goods that it needs to import will rise. China is already pushing down the prices of labour-intensive manufactured goods, thereby boosting the real incomes of consumers in developed countries. For example, average prices of shoes and clothing in America have fallen by 30% in real terms over the past ten years.

At the same time there will be a rise in prices of capital- and skill-intensive goods and services which China needs to import. Admittedly these gains for developed economies are being partly offset by higher prices for oil and other raw materials, which China also needs to import (of which more in the next article). But producers of raw materials, such as Australia, Brazil and South Africa, have gained handsomely over the past couple of years.

However, some countries may suffer a loss in their terms of trade, notably poor ones whose imports and exports are similar to China's. They will get lower prices for their exports and have to pay more for their imports of raw materials. A recent analysis by the IMF concludes that China's full integration into the global economy should benefit most of the world, but that some Asian countries, such as Bangladesh and Cambodia, could be net losers, especially once global import quotas for textiles and clothing are scrapped next January. Those quotas forced rich-world clothing companies to spread their production across many countries, but when they go, production is likely to become more concentrated in China.

•**Role model**. China's success could encourage other emerging economies to speed up reform. Jonathan Anderson, an economist at UBS, argues that China is one of the most rapidly liberalising economies in the world, and is opening markets far more than India or Brazil. Its reliance on imports and exports could well make it a champion for free trade.

Based on some crude assumptions, and on the expectation that other big emerging economies will copy it, China's economic integration could boost annual growth in developed economies by half a percentage point over the next two decades. Add in the faster growth in emerging economies themselves, and the world economy might enjoy growth of 1% a year more than it would have done otherwise. That would be close to most estimates of the boost to America's productivity growth from the IT revolution. The benefits from China's integration, however, could flow for much longer. China's GDP per head, measured at PPP, is still only one-eighth of that in America. Suppose that over the next 50 years China's real income per head rose by an average of 4-5% a year, lifting it to a still-modest half of that in America today. That would imply an increase in China's GDP (at PPP in today's prices) of more than $40 trillion—the equivalent of Christopher Columbus discovering four more Americas.

Individual countries can maximise their gains from Chinese integration and minimise their losses by making their own economies more flexible, increasing mobility between sectors and improving education. A study by the McKinsey Global Institute looked at what happened to workers who lost their jobs because of firms moving their production to low-wage countries such as China or India. McKinsey estimates that in America 70% of them find new work within six months, but in Germany only 40% do, partly because of a generous benefit system as well as strict hiring and firing laws.

Another study by Ben Broadbent, an economist at Goldman Sachs, suggests that consumers in the euro zone have also benefited much less from the outsourcing of production to low-cost countries than have consumers in America or Britain, who have enjoyed a sharp decline in the price of clothes in recent years. But in the euro area clothes prices have not fallen; like for like, they are now one-third higher than in Britain.

Mr Broadbent suggests that this is either because clothing manufacturers have been slower to outsource production or because there is less competition, so retailers have not passed on cost reductions. As a result, real incomes and hence consumer spending have grown more sluggishly in the euro zone. But for goods as easily traded as clothes, prices tend to converge over time. Clothes prices in the euro area should eventually fall steeply, boosting real household incomes and spending.

Four monstrous myths

In flexible labour markets, many of the workers who lose their jobs will eventually be re-employed in more productive industries. It is ironic, therefore, that American politicians and businessmen have been complaining most loudly about China stealing their country's jobs. With its flexible economy, America should adjust more easily than Europe. Fears about the threat from China stem from a series of widely held myths.

The recent decline in jobs in American manufacturing has coincided with a big increase in America's trade deficit with China, which reached $124 billion last year. According to the Cassandras, this proves that China is to blame for the job losses. But to look only at America's bilateral trade deficit with China is misleading. Much of the increase in America's imports from China has been at the expense of other emerging economies' exports rather than domestic production. For example, back in 1988 some 60% of American shoe imports came from South Korea or Taiwan and only 2% from China; today China has a share of 70%, and imports from South Korea and Taiwan have faded away. Over the same period America's imports of computers from the rest of East Asia have fallen as those from China have jumped.

America now buys goods from China that used to be made in Taiwan, South Korea or Hong Kong and have been outsourced to China. That does not mean that the East Asian tigers have suffered a loss; they have moved up the value chain to more skilled and less labour-intensive industries. The tigers now ship capital-intensive components to China for labour-intensive processing and assembly, to be re-exported to developed countries. For example, China imports motherboards, memory chips and other parts and exports personal computers. Thanks to this new global supply chain, China now has a trade surplus with America and Europe but a deficit with most of Asia (see chart 6). Its overall trade position is close to balance: China spends virtually all its export revenues on imports.

If China is “stealing” jobs from anybody, it is other emerging economies, not America. Mexico, in particular, is being squeezed. Despite NAFTA, it has already been overtaken by China as an exporter to the United States, and is likely to lose further market share to Chinese clothing producers when quotas are eliminated at the beginning of next year. But China cannot possibly be the main cause of manufacturing job losses in America, because apart from clothing, the biggest job losses have been in industries in which America's imports from China are small.

A second popular myth is that China is grabbing market share from the rest of the world. Yet over the past decade foreign multinationals' subsidiaries or joint ventures in China have accounted for two-thirds of the increase in China's exports. In other words, the explosion in those exports has more to do with foreign firms relocating their production to China than with Chinese businesses undercutting other producers.

“Exactly!” say the anti-China brigade: such relocation to China is the main culprit behind America's weak jobs market. American business lobbies and trade unions claim that offshoring has cost their country 3m manufacturing jobs in the past three years. But most of those job losses were likelier to have been caused by the recession or by labour-saving IT investment. Goldman Sachs estimates that in the past three years at most 1m manufacturing jobs have moved offshore. Unlike Asian firms, which tend to use China as an export platform, most American and European firms have invested in China primarily to sell to the domestic market.

Moreover, even if outsourcing does export jobs to China, part of the income created there flows back as increased demand for American goods and services. Work by Matthew Slaughter, an economist at the Tuck School of Business at Dartmouth College, finds that outsourcing also creates new jobs back home for engineers, finance and marketing experts to supply services or hi-tech components to foreign affiliates. In a study of 2,500 American multinational firms in the ten years to 2001, Mr Slaughter found that the number of jobs in their foreign subsidiaries rose by 2.9m, but in America itself by as much as 5.5m. Moreover, these firms' domestic employment increased faster than jobs in purely domestic firms.

Myth number three is that even high-skilled industries in the developed world are at risk because China is moving up the value chain to higher-tech goods, such as mobile phones and personal computers. It is true that electronic goods now account for 25% of China's exports, but then China's imports of electronic components have grown just as rapidly. China still concentrates mainly on the labour-intensive assembly of such components.

Ricardo redux

Last but not least, there is the myth that “China can make everything more cheaply,” so all jobs will eventually shift there from high-wage countries. Today capital and technology are mobile, so firms can move to wherever labour is cheapest. China's mix of low wages and rich-country technology, it is argued, will make it supercompetitive in everything.

But this argument rests on two misunderstandings. First, low wages go hand in hand with low productivity. As China's productivity increases, either wages or the exchange rate will eventually rise. If the latest technology could indeed lift China's average productivity to American levels, and global industry shifted there *en masse*, China's surplus labour would vanish and wages would soar.

Second, the case for free trade depends on comparative rather than absolute advantage. Even if China can make everything more cheaply than America, it will enjoy a much bigger cost advantage in labour-intensive industries such as making running shoes, because it has lots of cheap low-skilled labour. As David Ricardo admirably explained in the early 19th century, countries will be better off if they specialise in goods in which they have a comparative advantage and then trade with each other. America will always have a comparative advantage in something.

Fears that Chinese exports are growing at the expense of other countries are based on a fixed-lump-of-trade fallacy. In fact, trade is a positive-sum game: the more participants there are, the more opportunities arise, allowing countries to produce more with the same amount of labour and to obtain goods and services more cheaply. China's expansion will hugely add to those opportunities. But it will also put huge demands on the world's resources, as the next article will show.

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The big picture

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China stands much taller than other emerging economies

CHINA is only one of the world economy's emerging giants, along with India, Brazil and Russia. But it deserves special attention, because it has a bigger GDP than those three countries combined and, more importantly, it is much more integrated into the world economy, so its impact on other economies will inevitably be larger.

India's population is almost as big as China's (the two together account for 38% of the world total), and its long-term economic potential is promising, but at present its economic weight in the world is still relatively modest. China's GDP is more than twice the size of India's, and its share of the growth in global GDP since 2000 has been three times larger.

But the main difference is that China's exports of goods and services are about six times bigger than India's, and growing faster. In 2003, the increase in China's imports and exports in dollar terms was larger than India's total exports and imports. China's economy is much more open: by 2005 its average tariff on manufactured products will be 9%, compared with 30% for India. Foreign direct investment in China is 13 times bigger than that in India. India is far less integrated into the global supply chain.

Over the past 20 years, China's real GDP growth has averaged 9.5% a year, compared with India's 5.7%, and it is likely to outpace India's for at least another decade. It is true that India has better-developed institutions than China, with less corruption, an established rule of law and protection of property, but it lags badly in education and infrastructure, which along with openness to trade are key ingredients for rapid growth. Its adult illiteracy rate is 39%, compared with 9% in China. Another impediment to rapid growth is India's saving rate of 24%, only half China's rate and too low to finance the required investment in industry and infrastructure.

Bangalore's thriving software and IT services industry has caught the world's attention, yet information technology accounts for only 3% of India's GDP. Indeed, China has arguably embraced IT much more wholeheartedly than has India, with four times as many internet users.

Looking two decades ahead, India will probably overtake China in the growth stakes because its population is younger and growing faster, so its workforce will continue to expand when China's ageing population will start to slow it down. Although far behind in opening up, one day India will reinforce China's beneficial effect on the global economy.

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A hungry dragon

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Does the world have enough resources for China to keep growing at its present pace?

CHINA was overheating this summer in more ways than one. Because of electricity shortages, government offices were told to raise the temperature on their air-conditioning thermostats. Factories in some industrial areas also suffered blackouts and power rationing. China's rapid growth is putting huge demands on world supplies of energy and other raw materials. What will this mean for commodity prices?

China is already the world's biggest consumer of many commodities, such as steel, copper, coal and cement, and the second-biggest consumer of oil, after America, so changes in Chinese demand have a big impact on world prices. It is no coincidence that oil prices hit an all-time high this year. China still has a modest share of global oil demand, at 8%, but it has been responsible for nearly two-fifths of the increase in global consumption since 2000. China's surge in energy demand is also the main reason for the doubling in the world price of coal over the past year. Last year China consumed 40% of all the coal and 30% of all the steel in the world, and accounted for most or all of the increase in world demand for copper and steel. China is therefore responsible for much of the 50% rise in *The Economist*'s commodity-price index over the past three years.

China's oil demand has doubled over the past ten years. Its own oil production has increased much more slowly, so imports have had to fill the gap. Oil consumption has jumped by a spectacular 15% during the past year alone. This reflects not only the heavy needs of China's investment boom and a doubling of car sales since 2002, but also the side-effects of electricity shortages, which have forced companies to switch to diesel generators.

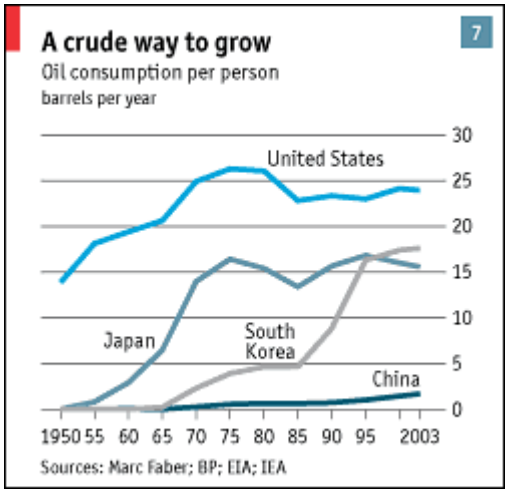
China's demand for energy is bound to rise further, but Scott Roberts, the director of Cambridge Energy Research Associates (CERA) in Beijing, thinks that over the next few years China's main effect on energy markets could be to increase price volatility. Higher energy prices and bottlenecks have already prompted a big rise in energy-related investment. Past experience in China suggests that this could lead to excess supply and lower prices within a year.

Moreover, what happens to oil and many commodity prices over the next year or so will depend largely on whether China's economy can engineer a soft landing. A slowdown in annual growth to 7%, as many economists predict, may sound soft enough, but investment could slow much more sharply, from an annual growth rate of 35% early this year to, say, 10%. Since investment spending is very raw-materials-intensive, such a slowdown could severely weaken commodity prices. World prices of copper, aluminium and steel slipped this summer as China's imports fell sharply. If China were to suffer a hard landing, the price of crude oil would surely drop.

In the longer term, however, continuing industrialisation and urbanisation will increase China's demand for raw materials and fuels. Economic development is always highly energy-intensive because basic industries tend to be big energy guzzlers. Moreover, as incomes rise, more households can afford cars and energy-consuming household appliances such as washing machines and air-conditioners. When incomes started rising in Japan and South Korea, their oil use per person rose sharply (see chart 7).

In around 20 years' time, China's income per person could be close to South Korea's today. If its energy consumption per person also rose to current South Korean levels, its energy demand would quadruple. The increase alone would be greater than America's total consumption today, yet China's energy use per person would still be only half that in America. At present there is only one car for every 70 people in China, against one car for every two Americans. If car ownership were eventually to rise to American levels, there would be 650m cars on Chinese roads—more than all

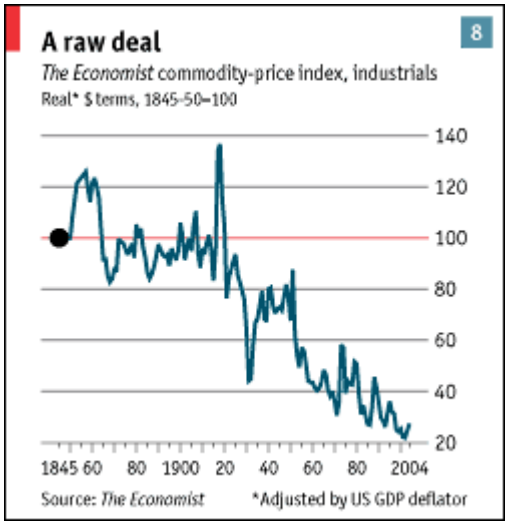
the cars in the world today.



Such forecasts have scary implications both for energy prices and for China's environment. But things may not be quite as bad as they look, not least because there is enormous scope for China to use energy more efficiently. For instance, it uses half as much energy again per tonne of steel produced as does Japan. But even if such waste can be greatly reduced, China's demand for energy will inevitably rise as car ownership climbs. CERA forecasts that energy demand will double by 2020.

Looking further ahead, if China's consumption of raw materials and energy per person were to rise to rich countries' levels, the world simply would not have the resources to supply them. But this argument is reminiscent of the Club of Rome's dire predictions in the early 1970s that the world would soon run out of natural resources. Rising demand in China (and other emerging economies, such as India) is likely to keep fuel prices high for the foreseeable future, because global spare capacity is currently tight. But rising prices will also curb demand and encourage new exploration and investment by oil producers to increase supply. These responses will help to contain the increase in prices.

Sweet-and-sour hog cycles



More generally, commodity prices are famously cyclical. An increase in the supply of metals or food in response to higher prices often leads to a glut soon afterwards. Another offsetting factor is that rich countries' demand for raw materials will fall as they continue to shift from manufacturing to services. After all, some factories being built in China are replacing those elsewhere. Globally, production is also becoming less commodity-intensive as producers shift to man-made substitutes, eg, from copper wire to fibre optics. Technological advances are also boosting supply in various ways, for example by improving rates of mineral extraction or increasing crop yields.

All the same, China's expansion is likely to halt the long-term decline in commodity prices relative to other prices. Even after the recent spurt, in real terms *The Economist*'s industrial-commodity-price index is still 75% below its level in 1845, when our index was launched (see chart 8). Prices are unlikely to return to where they started, but for commodity producers the future suddenly looks brighter.

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A fair exchange?

Sep 30th 2004
From The Economist print edition

China has helped to finance America's vast current-account deficit

UNTIL last year nobody seemed to care that the Chinese yuan was pegged to the dollar. But now China's exchange-rate regime has become one of the hottest topics in international finance—yet more evidence of China's growing influence on the world economy.

Many economists argue that China's fixed exchange rate distorts trade and investment flows. By refusing to allow its exchange rate to rise against the dollar, China, they say, is hindering the adjustment in global exchange rates needed to reduce America's current-account deficit, which now stands at more than 5% of GDP. As a result of its pegged exchange rate and large capital inflows, China's foreign-exchange reserves have more than doubled since early 2002 to over $480 billion, most of it in American government securities. China is not alone: other Asian economies have also intervened heavily to prevent their currencies appreciating. But sooner or later, those economists say, China will lose its appetite for dollars, causing the greenback to tumble.

However, Michael Dooley, David Folkerts-Landau and Peter Garber at Deutsche Bank reject this view. In a series of papers, they argue that America's current-account deficit will be happily financed by China and other Asian countries for at least another decade. The present arrangements, they say, look rather like a revived Bretton Woods, the system of fixed exchange rates that prevailed for a quarter of a century after the second world war. Once again, America is at the centre of the system. The old periphery consisted of Europe and Japan, which used undervalued currencies, supported by capital controls and the purchase of dollar reserves, to rebuild their economies after the war. But the new periphery is made up of China and other Asian economies which, it is argued, also peg their currencies to the dollar at artificially low rates. These countries want to keep their exports competitive in order to create jobs for their vast pool of underemployed workers.

But will America accept the political costs of rising imports and job losses in manufacturing? The three Deutsche Bank economists argue that China compensates America in two ways. First, it allows foreign firms to invest in Chinese factories, using cheap labour to earn fat profits (which turns those firms into an effective American lobby to counter resistance to Chinese imports). Second, the Chinese government invests a large chunk of its export earnings in Treasury bonds, helping to finance America's current-account deficit. This keeps American interest rates low and so supports consumer spending. In essence, China is buying dollar assets to ensure that Americans can afford to keep buying its exports. The return on Treasury bonds is lower than the returns at home in China, but, according to Messrs Dooley, Folkerts-Landau and Garber, the Chinese government is prepared to pay that price to ensure export-led growth.

America and Europe used to enjoy a similar relationship. The main question mark was, and still is, over the willingness of the periphery to accumulate claims on America. As Jacques Rueff, a French economist, put it in 1965 : “If I had an agreement with my tailor that whatever money I pay him returns to me the

very same day as a loan, I would have no objection at all to ordering more suits from him."

A marriage of convenience

This view of Asia's relationship with America helps to explain why in recent years it has proved possible to finance America's large current-account deficit without a bigger rise in American bond yields or a bigger fall in the dollar. However, the authors' claim that this arrangement is in the mutual interest of both America and Asia is questionable, as is their conclusion that America can therefore continue to run a large current-account deficit for another decade.

For a start, it seems doubtful that a cheap yuan is part of China's long-term development strategy. Until a couple of years ago, China's trade-weighted exchange rate was being dragged up by the strong dollar. China even passed up an opportunity to devalue the yuan during the Asian crisis. A second problem with the theory is the assumption that China can control both its exchange rate and its inflation rate. If a country holds down its nominal exchange rate, its real exchange rate tends to rise through the effect of higher inflation, which blunts its international competitiveness in just the same way. Indeed, large capital inflows into China are currently creating excess liquidity and pushing up its inflation rate.

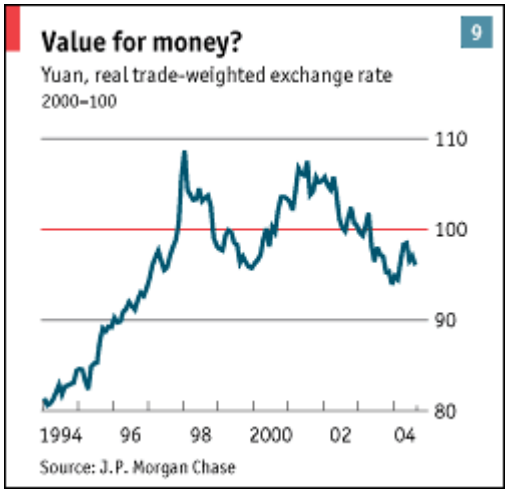
A third flaw is that in the original Bretton Woods system there was no real alternative to the dollar as a reserve currency. Today there is the euro, into which the Asians could diversify instead of holding dollars. And lastly, if China continues to run a large trade surplus with America and Europe while holding down its exchange rate, exporters may face mounting protectionism. The "revived Bretton Woods" may be a brief marriage of convenience, but there is a high risk of a messy divorce.

The marriage could prove particularly costly for America. In 2003 China and the rest of Asia financed over half of America's budget- and current-account deficits. This benefits America in the short term, but at the cost of allowing bigger imbalances to build up in the long term. The Asian central banks are masking market signals; America's current-account deficit reflects insufficient saving by households and an excessive budget deficit. Normally, investors would demand higher bond yields to compensate them for the increased risk, thereby giving the government a warning as well as an incentive to borrow less. But Asia's buying of Treasury bonds, with little regard for risk and return, is keeping yields artificially low, which makes pruning the budget seem less urgent. At the same time low interest rates prolong America's unhealthy consumer spending and borrowing binge.

James Carville, Bill Clinton's campaign manager, once said: "I used to think if there was reincarnation I wanted to come back as the president or the pope...but now I want to come back as the bond market. You can intimidate everybody." Thanks to the behaviour of Asian central banks, the bond market has lost its bark. It is subsidising rather than punishing American profligacy, allowing deficits to grow for longer. When the inevitable correction comes, it will be all the more painful.

True value

China's purchases of American bonds are clearly distorting financial markets, but how undervalued is the yuan? It is tricky to estimate the equilibrium exchange rate for a country that is undergoing massive structural change. The yuan was grossly overvalued in the 1980s and was then devalued several times. But between 1994 and 2001 its real trade-weighted index rose by 30% (see chart 9). Since the dollar started its decline, it has fallen by 11%.



According to some observers, the rapid growth in China's exports proves that China's exchange rate is too low. In fact it proves no such thing: China's imports are growing equally fast. And although China has a big trade surplus with America, its overall trade surplus has virtually disappeared so far this year.

On the other hand, China's large surplus on its "basic balance" (the current-account surplus plus net inflows of foreign direct investment) and its rising foreign-exchange reserves suggest that in a free market the yuan would rise. But in the longer term, if China scrapped its capital controls, the yuan would

probably fall as households diversified into foreign assets. Overall, therefore, the case for a big yuan revaluation is weaker than is commonly claimed.

American politicians shout the loudest for a yuan revaluation, but if it happened it would probably do little to reduce America's trade deficit. Few firms in America still make goods that compete directly with China. China's exports also have a high import content, so a rise in the yuan makes imported components cheaper, limiting the rise in export prices. According to a study by Lawrence Lau at Stanford University, only 20 cents in every dollar of Chinese exports to America reflect value added by domestic Chinese production, so even a 20% rise in the yuan against the dollar would increase the price of Chinese exports to America by only 4%.

Nevertheless, many economists think that the dollar does need to come down to help reduce America's current-account deficit, and China must play its part in that. Morris Goldstein, an economist at the Institute for International Economics in Washington, DC, reckons that the yuan is at least 15% undervalued. He feels that an appreciation on this scale would ensure both that China achieved an overall balance on its external payments (ie, it would run a current-account deficit sufficiently large to offset its underlying net inflow of capital) and that China bore its fair share of the adjustment in the dollar.

By itself a stronger yuan might make little difference, but it would encourage other Asian countries to revalue their currencies too. Asian currencies together account for 40% of the dollar's broad trade-weighted index. Unless they revalue, the euro will continue to bear the brunt of the adjustment in global current-account imbalances. Since mid-2001 the euro has risen by almost 50% against the greenback.

By far the strongest argument for a revaluation of the yuan is that it is in China's own economic interest. The dollar peg has, in effect, forced it to adopt America's super-lax monetary policy. Large capital inflows and rising foreign-exchange reserves have caused rapid growth in the money supply and bank lending as well as rising inflation. Excessive credit has fuelled over-investment and a property bubble, increasing the risk of yet more bad loans. The central bank cannot easily raise interest rates to cool down its economy, because that would attract more foreign money.

Moreover, an undervalued exchange rate, by subsidising exports, discourages investment in the non-tradable sector and cramps domestic consumption. A revaluation of the yuan would help to reduce China's reliance on exports as well as stemming the inflows of foreign money and allowing China to regain control of its monetary policy.

Easy does it

Until its shaky banking system has been stabilised, it would be foolish for China to open its capital account and let its currency float. That could risk massive capital flight and a banking crisis. Mr Goldstein instead suggests a two-stage currency reform. First, China would switch from pegging the yuan to the dollar to pegging it to a basket of several currencies, including the yen and the euro; its exchange rate would also be increased by 15% and its permitted trading band widened modestly to allow more flexibility. At a later stage, China could move on to liberalise capital flows and adopt a floating exchange rate.

Eswar Prasad, head of the IMF's Asia and Pacific department, disagrees. In a recent speech he argued that given the huge uncertainty about the correct level of the yuan, it made more sense to introduce greater exchange-rate flexibility for China as soon as possible rather than trying to settle on a particular exchange rate. A flexible exchange rate would help to buffer the economy against shocks. But greater flexibility should not be confused with fully opening up the capital account, which cannot safely be done yet. Indeed, says Mr Prasad, during the period of transition to a more flexible exchange rate, some capital controls might even need to be tightened to protect the banking system.

Whatever happens to China's exchange rate, it is clear that China is carrying increasing weight in international finance. Not only does America's monetary policy affect China, but increasingly China is affecting interest rates in America.

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Unnaturally low

Sep 30th 2004
From The Economist print edition

China is helping to keep down global interest rates

UNTIL recently, China was widely accused of exporting deflation to the rest of the world. Massive overcapacity in China, it was argued, was depressing the prices of manufactured goods. This year, however, the charge against China has been turned on its head. It is now being blamed for exporting inflation to the rest of the world as its insatiable demand for raw materials pushes up the price of oil and other commodities. Amidst this confusion, one thing is clear: the entry of China and other emerging economies into the global economy may affect monetary policy in ways that central banks do not yet fully understand.

To the extent that China adds to the world's productive capacity and strengthens competition, it should, on balance, help to reduce inflation for a period. A purist would argue that in the long run, inflation is determined entirely by monetary policy, but in the short to medium run cheaper imports from China will reduce inflation. A study by economists at America's Federal Reserve estimates that cheaper imports from China have lowered inflation in America by an annual average of 0.1-0.3 percentage points in recent years. Another study by Dresdner Kleinwort Wasserstein, which allows for the price-reducing effects of Chinese competition on all producers, reckons that China may have brought down America's inflation rate by almost a full percentage point. So what should central bankers do?

Last year, prompted by fears about deflation, America's Federal Reserve reduced short-term interest rates to a 45-year low of 1%. America's underlying rate of consumer-price inflation fell to only 1% at the end of last year, a bit too low for comfort. The experience of America in the 1930s and Japan over the past decade shows that deflation can be much more harmful than inflation: falling prices increase real debt burdens, depress demand and so push prices even lower. Deflation also emasculates monetary policy, because interest rates cannot fall below zero.

The right sort of deflation

The Fed is now celebrating its success in avoiding deflation. But Stephen King, chief economist at HSBC, argues that with hindsight some of the deflation that the Fed was fretting about last year was in fact “good deflation”, caused by structural changes in the global economy. Historically, benign deflation, of the sort experienced in the late 19th century at a time of rapid growth, has actually been more common than malign deflation, when prices and output spiral downwards. In recent years, cheaper imports from China and other emerging economies, along with the IT revolution (which has boosted productivity growth), have cut the prices of many goods and so, for a period, brought down inflation.

Mr King suggests that last year the Fed and some other central banks, fearing the bad sort of deflation, may have cut interest rates by too much and then left them low for too long. Instead, he says, they should have accepted this “good” deflation.

This is an echo of a lively debate in the 1920s, when some economists suggested that when rapid productivity growth is bringing down the cost of production, overall price stability may be the wrong goal. Instead, average prices should be allowed to fall to pass productivity gains on to workers in the form of higher real incomes. But just like today, monetary policy prevented prices from falling. Because nominal wage rises lagged behind productivity growth, profits surged. The mistaken belief that profits could continue to grow at this pace helped to inflate the late-1920s stockmarket bubble.

In retrospect, it is clear that the risk of deflation in America last year was exaggerated. Even so, it is hard to criticise the Fed's rate cuts in 2001-03. Even if some of the threatened deflation was of the good sort, there was a high risk of bad deflation after the bursting of the stockmarket bubble. At a time of weak growth, it was understandable that the Fed did not want to run the risk of any sort of deflation; it was

desperate not to repeat the mistakes of the Bank of Japan in the 1990s.

This does not mean that the Fed is blameless. The best concept for understanding the forces at work is the “natural rate of interest”, which goes back to Knut Wicksell, a Swedish economist working at the start of the 20th century. The idea was developed further by Austrian economists such as Friedrich Hayek. The natural rate of interest is the rate at which the supply of saving from households equals the demand for investment funds by firms. If the rate set by the central bank (the cost of capital) is lower than the natural rate, there will be excessive investment and borrowing, and households will not save enough. At the natural rate of interest, policy neither stimulates nor reins in the economy.

To make life tricky for central bankers, the natural rate can vary over time, in line with changes in the return on capital or households' desire to save. And there is good reason to think that the natural rate has risen in recent years. The entry of China's army of cheap, unskilled labour into the global economy has increased the ratio of labour to capital, which in turn lifts the worldwide return on capital. The spurt in productivity growth from IT has also increased expectations about future profits and investment opportunities, further lifting the natural interest rate. In other words, the very same forces that have caused central banks to cut interest rates to prevent inflation falling have actually increased the required equilibrium real rate of interest.

Meanwhile, households in many countries have decided that they need to save less than they used to, because they think rising share or house prices are likely to provide the assets to finance their retirement. In the economic jargon, the supply curve for saving has shifted backwards, whereas the demand curve for investment funds has shifted outwards. This implies a higher natural rate of interest.

Capital on the cheap

China has also caused the cost of capital to fall below its natural rate in another way. China and other Asian countries have been big buyers of American Treasury bonds, through heavy foreign-exchange intervention to hold down their currencies against the dollar. According to some estimates, that may have reduced bond yields by anything from half a percentage point to a full point. This “subsidy” has artificially lowered the cost of capital for homebuyers and companies, at precisely the time when the return on capital and hence the natural rate of interest has increased.

In theory, if central banks hold interest rates below the natural rate, credit and investment will rise too rapidly and households will save less and spend more. This is what has happened in America in recent years. Austrian-school economists would say that in the late 1990s interest rates were held too low in relation to the higher expected return on capital, which caused excessive investment, falling saving and the biggest stockmarket bubble in American history. Since the bubble burst, the expected return on capital may have fallen, but real interest rates have been cut by more, leaving them even further below their natural rate.

Holding interest rates too low for a prolonged period has created a whole series of excesses: a global housing bubble (of which more in the next article), rampant consumer borrowing and spending, and an unhealthy amount of investment in highly risky assets, such as emerging-market bonds, as investors searched for higher yield amid falling interest rates.

The exceptionally low cost of capital may also have distorted economies by encouraging firms to invest in labour-saving machinery rather than hire new workers. Thus, ironically, China may be indirectly to blame for America's jobless recovery. Workers are being priced out not by cheap Chinese labour, but by low-cost capital investment subsidised by the Fed's incorrect response to the downward pressure on inflation exerted by China.

As inflation has started to edge up, the Fed and other central banks have started to lift interest rates. But the risk now is that pushing real rates back to where they should have been in the first place will reveal the fragility of the recent economic recovery. Decisions taken on the basis of unsustainably low interest rates, such as borrowing to the hilt to buy an overpriced house, will suddenly look unwise. Aware of this risk, the Fed is lifting interest rates gradually. But a gentle rise may fail to halt the borrowing binge if expectations of future gains in house prices are entrenched, so the bubble may continue to inflate.

On the other hand, bigger rate increases (which may be unavoidable if inflation continues to rise) could cause a hard landing, triggering the bad deflation that central bankers have been so keen to avoid. Awkwardly, there would then be much less room for interest-rate cuts or fiscal stimuli than after the

stockmarket bubble burst, because most of the ammunition has been spent already.

A pinch of Basel

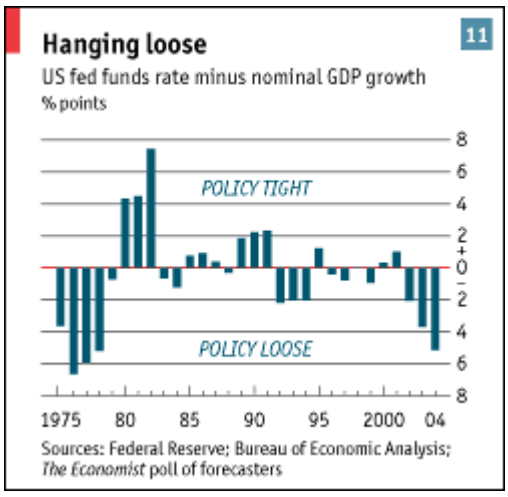
In its latest annual report, the Bank for International Settlements (BIS), the central bankers' central bank based in Basel, Switzerland, also expresses concern that monetary policy around the world has been too loose in recent years. The BIS frets that even if inflation is subdued in the short term, very low interest rates could either increase the risk of higher inflation in future or feed into financial imbalances such as excessive growth in credit and rising asset prices. Competition from China, deregulation and faster productivity growth have helped to hold down inflation, says the BIS, at the same time as financial liberalisation has increased the risk of booms and busts in asset prices.

Not only are structural forces such as globalisation helping to hold down prices, but central banks' success in the battle against inflation has also enhanced their credibility and reduced inflationary expectations. This has meant that they need not tighten policy by as much as previously in response to rapid growth in demand. Conversely, so long as inflation is subdued, they can afford to ease policy more freely to deal with economic downturns or during bouts of financial instability. The Fed has been doing exactly that in recent years, which has resulted in record low interest rates. This has reduced economic volatility in the short term (America's recession after the stockmarket bubble burst was the mildest in history), but the asymmetric policy could cause long-term problems by allowing bigger financial imbalances to build up. Rescuing investors each time a bubble bursts also encourages even more risk-taking.

The bottom line is that the extra liquidity created by lower interest rates is now more likely to spill over into asset prices and excess credit growth than into old-fashioned inflation. Liquidity has certainly been flowing freely in recent years. Monetary policy in the big developed economies has been looser than at any time for three decades. The Fed not only reduced short-term interest rates to a 45-year low, but it also made huge efforts to convince the bond market that rates would be kept low for a considerable period, thereby bringing down bond yields. Real short-term rates have been negative for the first sustained period since the 1970s (see chart 10). If the Fed sticks to its current slow tightening, real interest rates will remain negative well into next year.

The European Central Bank has been much criticised for running an overly tight monetary policy and thereby cramping growth in the euro area. Yet in fact, although interest rates in the euro area did not come down by as much as in America in 2001-03, real rates are also negative, and are at their lowest for over 25 years.

Another useful gauge of monetary policy is to look at the gap between interest rates and growth in nominal GDP. Nominal GDP growth can be seen as a proxy for the average rate of return on investment in America Inc, so this is a very crude estimate of the gap between actual interest rates and the natural rate. In both America and the G7 economies as a whole, the negative gap between interest rates and nominal GDP growth is currently at its widest since the 1970s (see chart 11).



Global supermoney

America's lax monetary policy has spilled over beyond its borders. Low American interest rates have encouraged capital to flood into emerging economies. For those countries that try to peg their currencies against the dollar, notably China and the rest of Asia, this has caused a large build-up in foreign-exchange reserves and excessive domestic liquidity. When central banks buy dollars to hold down their currencies, they amplify the Fed's loose monetary policy. All this means that, arguably, the Fed has not only caused the Americans to save too little, but also the Chinese to invest too much. Ed Yardeni, an economist until recently at Prudential Equity Group, tracks

the growth of what he calls “supermoney” (the sum of America's cash and banks' reserve holdings at the Fed, plus foreign reserves held by central banks around the world). He found that earlier this year supermoney was expanding at an annual rate of almost 25%.

In August 1977 *The Economist* published a signed article by Alan Greenspan, then a private-sector economist, which contained a list of five economic “don'ts”. One of them was: “Don't allow money-supply growth to spiral out of hand.” In recent years, Mr Greenspan seems to have inadvertently broken his own rule. As a result, America's economic recovery is built on wobbly foundations.

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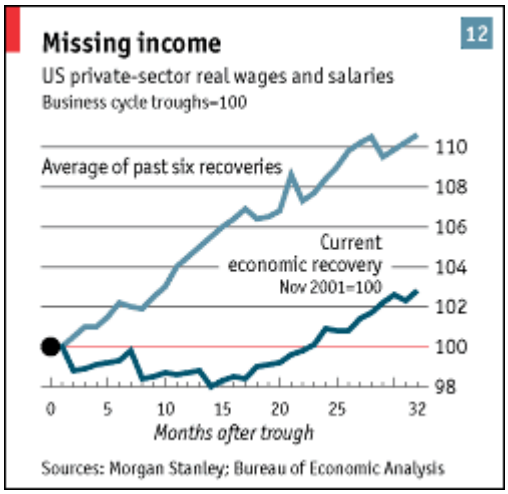
The great illusion

Sep 30th 2004
From The Economist print edition

Spending is increasingly being driven by higher asset values rather than higher incomes



MOST American economists will tell you that the Federal Reserve did a brilliant job in preventing a deeper and longer recession after the stockmarket bubble burst. Monetary policy has certainly been successful at keeping up consumer spending, but it has been less good for jobs and incomes. America's non-farm payrolls have risen by only 0.5% since the trough of the recession in November 2001, the weakest jobs recovery on record. Private-sector wages and salaries have risen by only 2.8% in real terms, compared with an average gain of 10.6% in the six previous recoveries (see chart 12). Yet despite this, consumer spending over the same period has surged by 9%. Wages and salaries in America as a proportion of GDP are currently at their lowest level for decades, yet consumer spending relative to GDP is at a record high.

The gap between income and spending has been financed partly by income-tax cuts, but also by saving less and by borrowing. Thanks to low interest rates the price of assets, especially homes, has risen steeply, which has made households feel richer and encouraged them to spend. This is happening not only in America but also in Britain, Australia, New Zealand, Spain and some smaller European economies. Household debt has jumped alarmingly.

Polonius's advice to Hamlet was, “Neither a lender nor a borrower be.” But borrowing is not necessarily a bad thing, so long as it does not get out of hand. Household debt in relation to income has steadily risen for at least half a century, largely because financial deregulation has made it easier for households to borrow. However, in the past few years debt has far outpaced its historical trend.

The Fed and others like to explain that there is no need to fret about the recent build-up of debt because it has been matched by big gains in the value of household assets such as shares and homes. President George Bush has boasted that America is enjoying its highest rate of wealth-creation for decades. The snag is that some of the “wealth” being built up by households is phoney. Rising home prices do not increase real wealth for society as a whole. Unlike a rise in equity prices, which in theory (if not always in practice) reflects expectations of higher future profits and an increase in an economy's productive potential, a rise in house prices does not reflect any increase in real productive resources (apart from improvements in the quality of homes); they are a wealth illusion.

Homes are not just assets, they are also a big part of living costs. For a given housing stock, when prices rise, the capital gain to home-owners is offset by the increased future living costs of non-home-owners. Society as a whole is no better off. Rising house prices do not create wealth, they merely redistribute it. Moreover, the prices of assets can fall. Debts, on the other hand, are fixed in value.

American households today are even more addicted to asset appreciation than during the late-1990s stockmarket bubble. Thanks to surging house prices and a partial recovery in share prices, the value of households' total assets rose by a record $6 trillion last year, equivalent to 70% of personal disposable income. Increases in property wealth also tend to have a bigger effect on consumer spending than increases in equity wealth. This is because more people own homes than shares and it is easier to convert capital gains on a home into spending power without having to sell the asset, by taking out a bigger mortgage. In 2003 housing-equity withdrawal (the total increase in mortgage debt minus net household investment in housing) rose to 6% of personal disposable income in America and to 8% in Britain. The housing stock has been turned into a gigantic cash machine.

In the long run, the only way to create genuine wealth is to consume less than your income (ie, save),

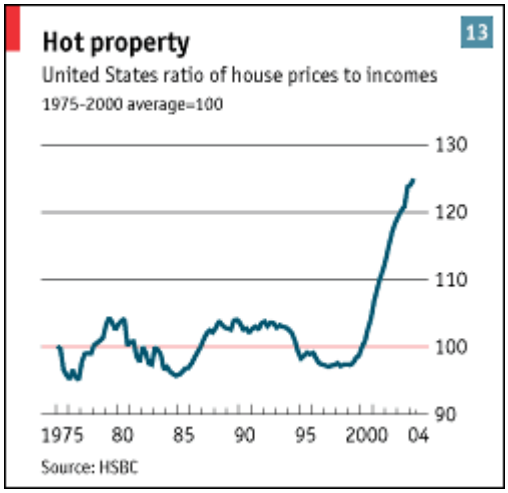
and invest in real income-creating assets. But America and some other economies have been enjoying a very different sort of wealth creation: central banks are, in effect, printing wealth by running lax monetary policies. Illusory paper wealth is boosting consumption at the expense of saving. America's net national saving rate, the share of income that Americans are putting aside for their future, has fallen to a record low, just when they should be saving more to prepare for an ageing society.

Where's my nest egg?

Why bother to save for your retirement when rising home values can do it for you? One good reason is that if the baby-boomers all try to sell their homes at the same time when they retire, house prices will slump. Even if asset prices do not collapse, households' expectations of continuing big gains in the price of houses and shares are highly unlikely to be met, so their nest eggs will be much smaller than they had hoped. For instance, most investors still expect equities to yield double-digit annual returns in the long run. After all, since 1982 the S&P 500 has delivered an average return of 14% a year.

However, a study by Martin Barnes at the Bank Credit Analyst, a Canadian investment-research firm, argues that equity returns over the next decade are unlikely to average more than 5-7% a year. This is because in the long run profits cannot grow faster than nominal GDP, which is now growing more slowly because of lower inflation, and share valuations are already high. If Mr Barnes has got it right, consumers will have to start saving in the old-fashioned way by spending less of their income.

Average house prices in America have risen by 40% in real terms since 1995. That may sound modest compared with gains of 120% in Britain and 80% in Australia, but the increase is twice as big as in America's previous booms in the late 1970s and the late 1980s, making this the country's biggest house-price boom in recorded history. The average ratio of house prices to incomes is already at a record level (see chart 13), yet people are buying homes in the unrealistic hope of large future price rises. That is the definition of a bubble. When two American economists, Robert Shiller and Karl Case, surveyed home-buyers in Los Angeles, Boston, San Francisco and Milwaukee last year, the respondents said they expected the value of their homes to rise at an annual average rate of 12-16% over the next ten years.



In the past, housing bubbles have mostly been fairly local affairs, forming in only one or two countries at a time. But now unusually low interest rates around the world may have fuelled the first global property bubble in history. Property prices have been rising briskly not only in America but also in Australia, Britain, China, France, Ireland, New Zealand, Spain and South Africa, among others.

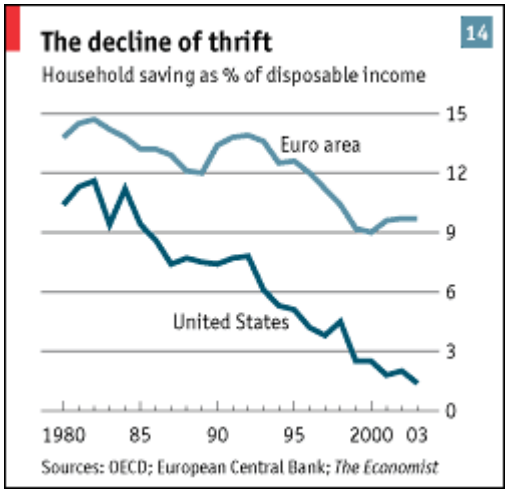
The housing-market analysts trot out all sorts of reasons why houses are not overvalued, such as low interest rates and rapid population growth. However, interest rates are now rising. Not to worry, say the optimists: 85% of American home-owners have fixed-interest mortgages (unlike most home-buyers in Britain, Australia and Spain, who have variable-rate loans), so they are not at risk. However, in recent months adjustable-rate mortgages have accounted for half of all new mortgages in America, leaving households exposed at exactly the wrong time. Despite low interest rates, households' total debt-service as a proportion of income is already close to a record high. And even if home-owners with fixed-rate mortgages will not be affected, new home-buyers will face higher mortgage rates. If first-time buyers are squeezed out, the housing market will quickly weaken.

After past booms, inflated house prices typically returned to normal levels by stagnating for a few years as incomes rose. But that is unlikely to work this time. Not only are houses more overvalued than ever before, as measured by the ratios of average home prices to incomes or rents, but inflation is low, so it would take many years of price stagnation for the real price to return to fair value. Over the next few years, house prices in many countries around the world are more likely to fall, leaving some households with homes worth less than their mortgages. The longer that home prices go on rising, the steeper their eventual decline will be.

A fall in house prices would have a much bigger economic impact than a fall in share prices. But even if house prices merely levelled out, consumer spending might slow down sharply because housing-equity withdrawal would decline. Mortgage refinancing in America has already plunged by 80% over the past

year in response to rising mortgage rates. Consumers' ability to turn capital gains into spendable cash has been a lifeline for the economy at a time when real wages were barely rising. That lifeline is now fraying, with consumer spending slowing down markedly in recent months. It may not be long before spending collapses.

European virtue



Most of the countries of the euro zone are less addicted to debt and asset-price inflation than the Anglo-Saxon world. Household debts in the euro area amount to an average of only 80% of personal disposable income, compared with 120% in America and 140% in Britain. Continental Europeans retain some of their faith in thrift. The average household saving rate in the euro zone fell from 15% of disposable income in the early 1980s to 10% last year. In America, in contrast, the household saving rate has plunged from 12% to less than 2% over the past two decades (see chart 14).

Some economists argue that the euro area's much higher saving rate is something of an illusion, caused by different institutional arrangements. For instance, if a large share of household services is provided by government spending (as in Europe) and this is financed from taxes on income, then both personal disposable income and private consumption will be reduced, so even if saving rates are identical in cash terms, as a percentage of disposable income they will appear higher.

Another distortion comes from households' contributions to pension funds. In the national accounts these are counted as saving if a worker contributes to a private pension scheme, but are not included if he contributes to a government pension system. This makes the saving rate in the euro area look smaller relative to America's. A joint study by the OECD and the ECB tries to adjust for these different institutional arrangements; it finds that the true gap in saving rates between America and Europe is even larger than the raw numbers suggest. However you look at it, Europeans are much bigger savers.

Much of the difference in saving rates probably reflects the less developed credit and mortgage-finance systems in the euro area, which make it harder to borrow. There is also much less marketing pressure to encourage households to take up loans. In the euro area, consumer spending is still driven mainly by income rather than by asset prices or borrowing.

A study by the OECD found that differences in the resilience of economies in recent years seem to be closely related to the performance of countries' housing markets. Consumer spending has generally been much stronger where increases in house prices have been largest, allowing consumers to borrow against their capital gains, as in America, Britain and Australia. In the euro area, by contrast, where house prices have generally risen by less, consumer spending has grown by an annual average of only 1% over the past three years, against 3% in America. Even within the euro area, differences in the strength of consumer spending can be partly explained by house prices. Spending has been weakest in Germany, where property prices have been falling, and strongest in Spain and France, which both saw double-digit price gains last year.

But it is not just the size of house-price changes that differs between countries. The OECD also finds that consumer spending is more sensitive to a given rise in house prices in some countries than in others. Such rises have the strongest “wealth effect” on consumer spending in America, Britain, Australia, Canada and the Netherlands, and the weakest in France, Germany and Italy. This is largely because in most euro-area economies it is much harder to turn capital gains into cash. Housing-equity withdrawal is significant only in Ireland and the Netherlands; in most euro-zone countries mortgage refinancing is very expensive.

Are American households overborrowed, or have Europe's sluggish economies made its consumers overly cautious? Either way, America's heavy debt burden will leave its consumer spending vulnerable to rising interest rates or falling house prices over the next few years.

A role reversal?

A more controversial question is whether America's underlying growth rate in recent years has been overestimated relative to that in the euro area. America's long-term potential growth rate is generally reckoned to be 3-3.5%, against only 2% in the euro area. But America's saving rate has been declining, temporarily boosting consumer spending and GDP growth; in future years it seems much more likely to rise, dragging down GDP growth.

And suppose that, thanks to increased liberalisation and competition in Europe's consumer-credit and mortgage markets, Europeans also learn to borrow and spend much more insouciantly, causing their average saving rate to decline over the next decade to 2%, America's current figure. That could add an impressive three-quarters of a percentage point a year to the euro area's growth in consumer spending for the next decade.

Several studies also suggest that Europe's annual GDP growth would be almost half a percentage point higher if it were measured in the same way as America's, so if the euro area's saving fell, its GDP growth over the next decade could easily match that in America. A European growth spurt would automatically make productivity increase faster. Stronger growth would also create a better climate for structural reforms to make labour markets more flexible. Before long, there would be a rousing welcome for Europe's “new economy”. That may sound far-fetched, but in fact it would not be that different from America's virtuous circle in the second half of the 1990s. America's falling saving rate helped to spur spending and hence GDP and productivity growth, bolstering share prices, which in turn encouraged less saving and more spending.

A fall in the euro area's saving rate to American levels would be unwelcome, because America is saving too little. But in the next few years the gap between America's and the euro area's saving and debt rates is likely to narrow. American consumers will have to rein back and save more, whereas Europeans might enjoy a bit of a spending spree. As America's wealth illusion is exposed and its economy suffers a prolonged slowdown, Europe could surprise everyone by doing better.

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The sun eventually rises

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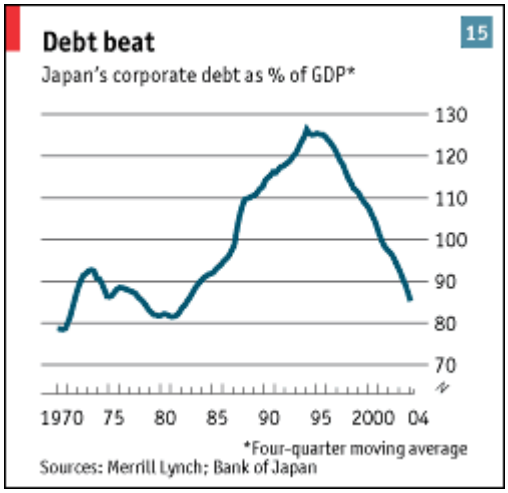
Japan has hitched a ride on China's boom

THE deflationary pressures felt in America in recent years may have been largely benign, reflecting increased global competition; but Japan's dose of deflation has been the nastier sort, caused by a collapse in demand when its late-1980s bubble burst. Deflation and economic stagnation caused Japan's nominal GDP to shrink by 4% in the five years to 2002. During the same period America's GDP expanded by 26%. Now, at last, Japan's economy seems to be reviving. In the year to the second quarter of 2004, real GDP grew by 4.2%, almost as fast as in the United States, and nominal GDP rose by 1.4%. But will this upturn prove any more sustainable than the two previous recoveries in the past decade, both of which soon fizzled out?

China's boom has played a big role in Japan's recovery. Last year Japan's exports to China rose by 68%, accounting for two-thirds of its total export growth and one-quarter of its real GDP growth. If the increase in capital spending by exporters is added in as well, then China accounted for somewhere between one-third and one-half of Japan's GDP growth. On present trends, China (including Hong Kong) will overtake America as Japan's biggest export market some time next year.

Whereas Japan's two earlier economic recoveries were kick-started by fiscal stimuli, which soon ran out, this one has been led entirely by private-sector demand. Years of corporate restructuring are at last bearing fruit. Firms have cut costs and pruned excess capacity and debt. Big firms' profit margins are now close to their highest in 30 years, the ratio of total corporate debt to GDP is at its lowest since the early 1980s (see chart 15), and business confidence is at its strongest for over a decade. Firms have started to invest more over the past year, and unlike in the previous short-lived recoveries unemployment has fallen. Retail sales remain weak, but consumer confidence has risen to its highest level since 1991, which means spending should pick up in the coming months. Deflation is also easing, thanks partly to the Bank of Japan flooding the economy with liquidity.



Richard Jerram, an economist with Macquarie Securities in Tokyo, reckons that the economy has never been in better shape since the bubble burst more than a decade ago. Perhaps the biggest difference between this recovery and the previous false starts, he says, is that the banking sector is close to becoming solvent. Banks have tried to clean up their balance sheets and there are fewer non-performing loans as the upturn improves borrowers' creditworthiness. In effect, a cyclical export-led recovery is helping to solve Japan's structural problems.

On the other hand, Japan's recent growth rate of more than 4% is unsustainable; Japan's long-term potential growth rate is estimated to have fallen to only 1-1.5% because the labour force is shrinking. Yet with the economy still operating well below capacity, that leaves room for a couple more years of above-trend growth.

But could a hard landing in China drag Japan down too? The gloomy view, offered by Andy Xie, Morgan Stanley's economist in Hong Kong, is that it would cut short Japan's revival. At first sight Japan looks highly vulnerable, given that exports to China accounted for such a large part of Japan's GDP growth last year. If China's investment boom were to turn to bust, Japanese exports of steel, chemicals and construction machinery would be badly hit. Indeed, these exports have already been growing much more slowly this year, reflecting the recent slowdown in Chinese investment.

However, Peter Morgan, an economist at HSBC, argues that most of Japan's exports to China are associated with Japanese firms shifting their production to China to cut costs, so the trade figures exaggerate Japan's true exposure to Chinese demand. A big share of those exports are components, such as semiconductors, that are assembled in China for final export elsewhere. Such exports depend more on the strength of demand in America, Europe and Japan, and will not be much affected by a slowdown of domestic spending in China. Mr Morgan estimates that even a hard landing in China, with investment growth falling to zero, would slice only 0.4% off Japan's GDP growth over two years.

But what if demand in America, currently Japan's biggest export market, also slowed sharply? And even if the direct impact of a slump in China were to be modest, the indirect impact on business confidence, stockmarkets and trade within the whole Asian region would probably be much more serious.

The death of deflation?

Japan will remain particularly vulnerable to any external shock from America or China while deflation persists. Despite rapid real GDP growth over the past year, the GDP deflator fell by 2.7% in the year to the second quarter, and consumer prices declined by 0.1% in the year to July. The Bank of Japan has promised that it will stick with its current policy of zero interest rates and quantitative monetary easing (basically, printing money) until consumer-price inflation has been positive for several months and is expected to remain positive. The bank is therefore unlikely to tighten policy before the middle of next year at the earliest. But there is already intense debate about its best “exit strategy” from its current loose policy.

Many economists say that the Bank of Japan should set an inflation target of, say, 1-2%. That would help to convince financial markets and households that it will not repeat its mistake in 2000 when it raised interest rates prematurely, pushing the economy back into recession. At the same time it would also reassure financial markets that the central bank will not allow inflation to get out of hand. Some bond investors are fretting that the overhang of bank reserves created by the central bank's policy over the past couple of years could in due course result in a sharp jump in inflation.

But should the bank set a target for the annual inflation rate or for the price level? With an inflation-rate target, any undershooting of the goal is treated as over and done with, but with a price-level target any undershooting must be made up for later by a period of overshooting, so the inflation rate aimed for can vary from year to year. In general, central banks prefer to target the inflation rate, partly because a price-level target is harder to explain, and partly because the need to reverse previous deviations from target may make output more volatile.

However, Takatoshi Ito of Tokyo University and Frederic Mishkin of Columbia University argue that whereas inflation-rate targets may be best in normal times, once an economy is suffering deflation there is a stronger case for a price-level target because it requires a compensating period of higher-than-normal inflation. Suppose that the Bank of Japan set a target for the price level based on an average inflation rate of 1% since 1998. That would have required average prices to rise by 6% by 2004. Instead, prices have fallen, so to get back on target from their current level would require prices to rise by about 2.5% a year for the next five years. That would do much more to help lift inflationary expectations than setting a conventional 1% inflation target; it would therefore have a bigger effect in reducing real interest rates.

Another good argument in favour of a price-level target is that it helps repair balance sheets, so the financial system can work properly. A price-level target that aimed to restore average prices to where they would have been without deflation would erode the real burden of debt and reduce banks' non-performing loans. Banks would then be able to start lending again, and firms would be in better shape to borrow and invest. This should not be seen as “bailing out” debtors, because most of those debts were taken on before deflation emerged. It would simply be winding back the clock to put banks and borrowers in a fairer position.

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New policies for a new world

Sep 30th 2004
From The Economist print edition

Yesterday's financial architecture needs refurbishing

AMERICAN consumer spending and Chinese fixed investment have both slowed markedly in recent months. A synchronised slump in the two economies could nudge the world economy towards recession. America's and China's booms have been reinforcing each other. Low American interest rates encouraged capital to flood into China, fuelling its investment boom, and American consumers bought lots of Chinese exports. At the same time, America's imports of cheap Chinese goods and cheap Chinese capital (in Treasury bonds) have held down inflation and interest rates and so supported its spending binge. However, the resulting excessive consumption in America and excessive investment in China have both become unsustainable.

Most commentators still hope that the Chinese authorities can achieve a soft landing, but investment booms typically end more painfully. This survey has argued that even if China suffers a sharp slowdown over the next year or so, its long-term growth prospects remain good. But to minimise the future risk of excessive booms and busts, China needs to reform its banking system to ensure a more efficient allocation of capital, and to make its exchange rate more flexible to regain control over its monetary policy.

America's immediate challenge is to increase interest rates without causing over-indebted consumers to take fright. Artificially low interest rates have encouraged households to save too little and borrow too much. The risk is that as short-term interest rates return to normal levels of 4-5%, the housing bubble with its attendant mortgage-refinancing bubble will burst, exposing the flimsy foundations of America's recovery.

The longer-term challenge for the Fed and other central banks is to build a new monetary-policy framework that takes account of recent structural changes in the global economy, such as the integration of China. For more than two decades, central banks' main task was to fight inflation. Now and in the coming years, the banks will increasingly have to deal with booms and busts in credit and the prices of assets such as homes and shares.

Cheaper goods from China, combined with faster productivity growth thanks to IT, have held down inflation, and excess liquidity has instead been bottled up in asset markets. At the same time, a long period of low inflation has anchored inflationary expectations, so prices and wages are less likely to take off if demand grows faster. With inflation under control, central banks are inclined to keep interest rates low and thereby unwittingly accommodate an unsustainable boom in credit and asset prices.

Asset-price inflation is just as harmful for economies as inflation in the prices of goods and services. Just as conventional inflation can distort the allocation of resources, so asset-price inflation distorts economic behaviour by causing households to save too little and to pour too much money into property. Booms

and busts in asset prices can pose as much of a threat to economic stability as conventional inflation.

The recent surge in house prices around the world has revived the debate about whether central banks should raise interest rates to cool down asset inflation. The Federal Reserve's Alan Greenspan has declared himself fully vindicated in his decision not to prick the stockmarket bubble in the late 1990s, but instead to wait for it to burst and then cut rates sharply to cushion the economic consequences. A central bank, he argued, cannot be sure that it is really dealing with a bubble until it has burst, and raising rates by enough to prick a suspected bubble could itself set off a deep recession.

Claudio Borio, an economist at the BIS, and Philip Lowe, at the Reserve Bank of Australia, have tried to shift the emphasis of this debate away from the question of whether central banks should prick a bubble. Instead, they look more broadly at financial imbalances, particularly excessive growth in credit, which tends to signal problems ahead. Their analysis suggests that large simultaneous deviations from trend in both the growth of credit relative to GDP and in real asset prices are usually good predictors of financial strains and can provide useful information about future output and inflation.

If it is possible for central banks to identify the build-up of financial imbalances in good time, then they can restrain those imbalances, rather than just waiting to offset the economic consequences of their unwinding. Messrs Borio and Lowe argue that central banks need to pay more attention to excessive growth in credit even when inflation is subdued. Thus they might set broad targets for credit growth alongside an inflation target.

An increasing number of central banks, such as the Bank of England, the European Central Bank and the Reserve Banks of Australia and New Zealand, now support the view that monetary policy should sometimes act to restrain a rapid increase in credit and asset prices. Indeed, this was one of the main justifications for raising interest rates in Britain this year. Likewise, the ECB has pointed to the “second pillar” of its monetary-policy strategy, which monitors growth in money supply and credit, to explain why it did not ease policy more. Otmar Issing, the bank's chief economist, argues that central banks cannot afford to ignore asset prices and credit. Among the main central banks, only the Fed still seems to reject this advice.

Time to join the club

Another way in which today's rich economies need to adjust to China's integration into the world economy is to include the country in international economic-policy forums. Absurdly, China is not a member of the G7 group of finance ministers and central bankers (which embraces America, Japan, Germany, Britain, France, Italy and Canada) or the G8 (which also takes in Russia). When the G7 was set up in the 1970s, the current members did call the shots on global growth, trade and currencies, but today China's economy, even if measured at market exchange rates, is bigger than that of either Canada or Russia, and measured at PPP it is already the second-biggest. China is also the world's third-biggest trader, and holds the largest foreign-exchange reserves after Japan.

At most of their meetings over the past year, G7 finance ministers have called on China to make its exchange rate more flexible. Yet China has not been present to take part in the discussion. At the G7 meeting in Washington in early October it will be hovering at the fringes, but it should now be offered full membership. Without it, the G7 will soon become an irrelevance.

Bringing China into the G7 might also be a good way to discourage protectionism in America and Europe as China's exports continue to expand. Economic relations between America and China are already strained because of concerns about America's big trade deficit and its job losses. China is the biggest target of American anti-dumping duties, which cover around 60 Chinese products. A proliferation of trade barriers would block the world's most powerful source of future prosperity.

Instead, developed countries should concentrate on maximising the gains and minimising the losses from China's development. That requires open product markets, flexible labour markets and better education and training to help workers who lose their jobs find new ones. Membership of the G7 would also give China a bigger stake in the smooth functioning of the global economy. Current spats about its exchange rate are insignificant compared with the risk to the world economy if this powerful engine of growth were to break down or even close its borders again.

There are some worrying similarities between today and the early 1970s, when the emergence of a new economic giant, Japan, was widely seen as a threat to jobs elsewhere; commodity prices were also rising

rapidly and monetary policy was too loose. In response, other countries became more protectionist, and inflation took off, leading to slower and more volatile growth. The world cannot afford to make the same mistake again.

Asked about the effect of the French Revolution on world history, Zhou Enlai, China's prime minister from 1949 to 1976, is said to have replied: “It's too early to tell.” With luck, the benefits of China's economic revolution will become obvious much more quickly.

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Sources and acknowledgments

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Fashion

King of the catwalk

Sep 30th 2004 | MILAN
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Reuters

Giorgio Armani is grappling with the problem of succession at Italy's most glamorous fashion firm

IT IS fashion week in Milan, but Giorgio Armani has bigger worries than how his 2005 collections will be received. The founder, chief designer and chief executive of the eponymous fashion firm must prepare his company for the future. Although Mr Armani is still going strong, he is also 70, and has neither a designated Dauphin nor a family member to replace him. He needs to decide whether his company can survive his own leadership, either as part of a big group, in partnership with another fashion firm or on its own, perhaps as a listed company.

Mr Armani is the last of his generation to address the issue of succession. In part that is because, as one of the most successful Italian designers, he has not been forced to by financial constraints. His peers, Valentino Garavani, 72, Emanuel Ungaro, 71, and Gianfranco Ferré, who is 60, have already made arrangements for the future. And the relatives of the late Gianni Versace are fighting for the survival of his company. These grey panthers established their firms in the halcyon days of Italy's economic "miracle", and until recently they remained one-man shows.

Most, however, still retain some creative influence over the firms they founded, which means the transition to a new generation still has some way to go. Mr Garavani's Valentino brand was taken over by the Marzotto Group in 2002, but he continues as its head designer. Mr Ungaro sold his firm in 1996 to Ferragamo, a Florentine luxury firm, but still works closely with Gianbattista Valli, who became the firm's creative director three years ago. Mr Ferré's company is now owned by IT Holding, which has a handful of luxury-goods firms, and he remains the firm's main designer. Donatella Versace, who took over after her brother's death in 1997, Santo Versace, another sibling, and a niece, are searching for an investor or buyer for their debt-laden firm. Valentino, Ungaro, Ferré and Versace all lost money last year.

That Mr Armani has been steadily profitable for 30 years gives him more options to consider for his much bigger firm. On September 30th, Armani said group sales in the first half of 2004 were up by 8% to €644m ($790m), compared with the same period a year earlier. Pre-tax profits were up 23% to €89m.

How does Mr Armani do it? Margins of his ready-to-wear fashion are among the best in the industry. He diversifies into new lines without cheapening his brand. And, so far, he has been a master at combining creativity with commercial savvy.

He also managed to avoid some of his rivals' mistakes. Led by France's Pierre Cardin, the pioneer of fashion licences, Christian Dior, Yves Saint Laurent and many Italian designers allowed others to use their brands. But Mr Armani kept a handful of licences under tight control. In 1980 he signed an agreement with L'Oréal for the production of scent and cosmetics, and struck a deal with Luxottica, the world's largest producer of spectacles. Fossil, an American firm, makes Armani-badged jewellery and watches. Wolford became a licensee for Armani underwear this year.

But Mr Armani can be too hands-on for some. Last year he clashed with Luxottica's management when he tried to interfere in the design of their glasses and insisted that they should be made more exclusive by restricting sales. After an acrimonious row, Mr Armani replaced Luxottica with Safilo, another eyewear-maker.

In the late 1990s, Mr Armani stayed away from other brands, despite the increasing popularity of the multi-brand strategies adopted by other luxury-goods firms. Bernard Arnault, the boss of Moët Hennessy Louis Vuitton (LVMH), the biggest luxury-goods conglomerate with some 50 brands, started the trend. His arch rival is François Pinault, the boss of Pinault-Printemps-Redoute (PPR), which owns another stable of luxury companies. Italy's Gucci and Prada took on huge debts to gobble up rival luxury brands. Today LVMH is still losing money with Fendi, a Rome-based fashion house, and French fashion houses Givenchy and Céline. PPR, which bought the Gucci group earlier this year for €7.2 billion, has not yet managed to turn around Yves Saint Laurent and Boucheron, a jeweller.

Single-brand firms are more exposed to the fickleness of fashion, but Mr Armani hedged against such volatility by consistently sticking to his minimalist style. His timeless designs never went out of fashion. On the other hand, Mr Armani has never managed to create the buzz of John Galliano, whose cutting-edge clothes made Christian Dior profitable again.

Mr Armani was among the first to develop a series of sub-brands to cater to different groups with different prices, ranging from extremely expensive to merely pricey. He has six: Giorgio Armani, Armani Collezioni, Emporio Armani, Armani Jeans, Armani Exchange and Armani Junior. And he also dabbles in interior design, coffee shops, flowers and sweets. He recently opened a nightclub in Milan. A new joint-venture, together with EMAAR, a Dubai property developer, is a chain of hotels. “Armani managed to democratise the brand and keep it exclusive,” says Françoise Paumard, a luxury-goods analyst at Exane BNP Paribas in Paris.

Almost all fashion designers need a good business manager. Christian Dior had Jacques Rouët; Yves Saint Laurent had Pierre Bergé; and Valentino has Giancarlo Giammetti. In August Giancarlo di Risio took over as chief executive at Versace. But for years, Mr Armani has played both roles, after taking on the management job following the death of his company's co-founder, Sergio Galeotti, in 1985. “I am a salesman of ideas and products,” says Mr Armani. Ms Paumard uses the term *créateur commerçant*, a creator-shopkeeper.

But who might buy the shop? Analysts estimate Armani's value at €2 billion-3.5 billion. Mr Arnault is still keen, despite being rebuffed by Mr Armani a few years ago. L'Oréal is another possible suitor, but cosmetics is a very different business. Bulgari and Hermès are too small to acquire Armani, while the priority of PPR and Prada is to reduce their debts, says Antoine Colonna, a luxury-goods analyst at Merrill Lynch in Paris. Some wilder guesses are EMAAR, Armani's partner in hotels, and Chanel, a fashion firm owned by the Wertheimers, a secretive French family.

In the right hands, Armani might continue to thrive even without its chief designer cum chief executive. After all, following Coco Chanel's death her company did well under Karl Lagerfeld, who also managed to combine design with commercial flair. But unless Mr Armani is clear-headed and brave enough to designate a successor of some kind, his firm might not be so fortunate. A test case could be Gucci. Its designer, Tom Ford, and Domenico De Sole, his business partner, left abruptly earlier this year after being refused the financial deal they demanded. The jury is still out on the team that PPR put in to replace them. On September 28th, PPR's Gucci division announced operating profits up 18% in its second quarter to €103m, which was encouraging to many in the fashion business. But the real test will come on Milan's catwalks this week when the collections produced by Gucci's new designers make their debut. Mr Armani will be watching closely.

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Space tourism

Virgin territory

Sep 30th 2004
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Sir Richard Branson aims for the moon

Reuters

Beam me up, Burt

BRITAIN'S best known entrepreneur is a launch junkie. When Sir Richard Branson this week announced plans to enter space tourism with a company called Virgin Galactic, his Virgin group also unveiled a new online music store and a start-up airline in Nigeria that will become that nation's flag carrier. Meanwhile, the entry into service of Virgin Rail's new high-speed tilting trains on Britain's London-Glasgow line was marred by delays and cancellations: plainly Euston had a problem.

While it is easy for cynics to mock Sir Richard and his extra-terrestrial showmanship, he should have plenty of spare cash after the successful flotation of his Australian airline and his mobile-phone businesses—enough to invest $100m in his space venture. Moreover, the business plan that he and his partner Burt Rutan are working on sounds perfectly, er, down to earth.

Mr Rutan is the brain behind *SpaceShipOne*, which in June became the first privately funded spaceship, reaching the edge of space on a sub-orbital hop. Mike Melvill, the pilot, repeated the trick on September 29th, when *SpaceShipOne* made the first of two flights necessary to win the $10m Ansari X-Prize. This will be awarded to the first successful private effort to send a craft capable of taking three people into space twice in two weeks. But the qualifying flight may come even sooner than that. The clever thing about Mr Rutan's aircraft is that it can tumble back into the atmosphere and glide down to land without any fancy computerised guidance.

Sir Richard is offering seats on his flights for £115,000 ($210,000), to include three days of training and about three minutes of weightlessness in space. Being the man he is, Sir Richard is naturally talking about a space hotel and orbital flights leading, one day, to trips to the moon. He plans to start selling seats early next year, with the first flight to follow two years later, subject to regulatory approval. That looks like powerful business logic, putting the getting before the spending. Virgin Galactic expects 3,000 rich people to sign up.

Mr Rutan developed *SpaceShipOne* with finance from Paul Allen, a Microsoft billionaire. Sir Richard is licensing the spaceship technology developed by Mr Allen's company, Mojave Aerospace Ventures. Mr Rutan says that the technology to do private space flight has been around for over ten years, thanks to new composite materials that combine light weight with strength. He reckons the flights will be as safe as those during the early years of civil aviation. Convincing regulators of that might be one of the biggest hurdles in the new venture's flight path.

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Online travel

Bon voyage

Sep 30th 2004
From The Economist print edition

Orbitz gets a new owner and a new deal

Get article background

THINK of it as similar to a big food manufacturer buying up a grocery store. On September 29th, Cendant, an American property and travel conglomerate, paid $1.3 billion in cash for Orbitz, an online travel site. The deal represents part of a long-expected consolidation of the online travel industry. But it is less about combining travel sites themselves, and more about the marriage of physical inventory, such as hotel rooms, holiday apartments and rental cars, with an increasingly successful sales medium: the web.

By teaming up with Cendant, Chicago-based Orbitz moves ahead of Travelocity to become second only to Expedia in the online travel business. All three American companies benefit from discounting products which their parent companies own or control. Travelocity is owned by Sabre, which operates a global distribution and ticketing system for airlines and hotels. Expedia is owned by InterActiveCorp (IAC), through which former Hollywood mogul Barry Diller operates a series of online businesses selling everything from tickets to sporting events to hotel rooms and dating services.

Orbitz's strength is cheap air tickets, sales of which account for roughly two-thirds of its revenue. Like other online travel agents, it is also trying to get into business travel, which has higher margins. It was originally conceived as a way for its founders—American, United, Delta, Northwest and Continental airlines—to sell directly to customers and so avoid paying commissions to other travel sites. But America's airlines are in financial trouble and need cash.

Under Cendant, the strategy takes a different turn. Like Expedia, Orbitz will bring together Cendant's travel firms. But in this case, they are Cendant's tangible assets: the actual rooms of hotel chains like Howard Johnson, Ramada and Days Inn; the actual cars of Avis and Budget. Previously, Cendant operated sites that specialised in certain areas, such as air tickets and lodgings, but on their own failed to achieve meaningful size. Cendant can use Orbitz to aggregate its assets into a single sales channel that can be displayed on its customers' computer screens.

This will also help to offset the loss of sales from old-style industry reservation systems. Cendant also owns Galileo, a rival to Sabre. As more travellers switch to using do-it-yourself online travel agents, the industry systems will become less important as direct sales channels.

The majority of all travel purchases are expected to take place online within a decade. In America, online bookings will rise from around $53 billion this year to $111 billion by 2009, according to Forrester Research. Travel websites already represent roughly 45% of all online sales in America. Yet the industry's record could be even more impressive, save for two stumbling blocks. Many people research travel options in cyberspace only to book their trip through a retail travel agent. Second, many use multiple sites to purchase different elements of their trip.

That places a premium on sites that are able to offer one-stop shopping with the lowest prices. But the cosy relationship between shop window and inventory owner may not be all that appealing to customers. They will rightly suspect that Orbitz is not an independent travel shop scouting out the best deals for them, but one that deliberately pushes travel options from Cendant's subsidiaries to the top of its list of offerings. After all, that is precisely what Cendant must want Orbitz to do. Businessmen call this “synergy”. Whether customers also see it as a good deal remains to be seen.

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Russian oil

Luk warm

Sep 30th 2004 | MOSCOW
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How welcome are foreign firms in Russia's energy sector?

Get article background

IT LOOKED like an old-fashioned Russian privatisation. The auction on September 29th of the Russian government's 7.6% stake in Lukoil, an oil company, lasted less than two minutes. The successful bidder had been publicly encouraged by both Vladimir Putin, Russia's president, and Lukoil's management. Less traditionally, however, the state sold its asset for a fair sum (judged against Lukoil's current share price); and the buyer was a foreigner.

ConocoPhillips, an American oil firm, bought the Lukoil stake for almost $2 billion, making the purchase the biggest privatisation in Russian history—although that accolade reflects the corruption of the cut-price giveaways of the 1990s as much as the scale of the new deal. Conoco said it would like eventually to increase its Lukoil holding to around 20%, and elaborated plans for co-operation in Russia and Iraq.

Last week, Total, a French company, agreed to pay close to $1bn for a 25% stake in Novatek, Russia's largest private gas producer, though a minnow in comparison to the state-run behemoth Gazprom. Until the Lukoil auction, Total's had been the biggest foreign investment in the Russian energy sector since Britain's BP in effect bought half of TNK, another oil firm, last year. There was good news for investors on Gazprom, too: the Russian government reiterated its plan to remove the restrictions on foreign share ownership after the company merges with Rosneft, a state-owned oil producer.

This liberalising momentum has helped to ameliorate the queasiness brought on by the Yukos saga, which continues on its macabre and seemingly interminable course. Yukos has suspended 60% of its rail exports to China, making good a threat it embarrassingly made just before the Chinese prime minister's recent visit to Moscow. Yukos has also announced a massive (if preliminary) upward revision of the reserves held by Yuganskneftegaz, its main production arm—just as Dresdner Kleinwort Wasserstein (DKW), a German bank, completes its evaluation of it, possibly in advance of a sale by bailiffs to settle Yukos's tax bill. Meanwhile, the government was this week on the verge of withdrawing Yuganskneftegaz's production licences, for non-payment of taxes. The company would probably have 90 days to pay up and keep the licences; but the threat alone may have the not coincidental effect of depressing the DKW valuation towards a level the government would like.

Should Yuganskneftegaz go under the gavel, the likeliest buyers are Gazprom-Rosneft, Surgutneftegaz (a Kremlin-friendly private operator), or both. Last week, Mr Putin said tellingly that while, of course, there had never been a plan to re-nationalise Yukos, state-owned companies would nevertheless be entitled to bid for its assets should they come up for sale. Therein lies the limit to the hospitality Russia is likely to extend to western energy firms: it is virtually inconceivable that they would be welcome bidders for a strategic asset such as Yuganskneftegaz. Mr Putin has made clear his intent to consolidate the state's hold on the energy sector, which is, after all, probably his principal foreign-policy lever, as well as his golden goose.

So foreigners are welcome—for their capital, and for the expertise needed to exploit new and offshore resources, such as those in the Sakhalin shelf north of Japan—but probably not, any more, in the sort of role BP secured with TNK. In any case, there are still plenty of risks in the Russian energy business, as Chris Weafer, chief strategist at Alfa-Bank, enumerates: apart from uncertainty over the licensing regime and taxation, there is Russia's dallying over the construction of new oil pipelines. And there are precious few Russian oil firms left to bid for. On the other hand, resource-thirsty western companies have little choice but to court their favour.

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Cement

One giant leap for Mexico

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Mexico's biggest cement-maker plans to buy Britain's biggest

IT IS 98 years old, it employs 26,000 people, its 2004 turnover will be nearly $8 billion, and this week it offered £2.3 billion ($4.1 billion) for a smaller rival. There is nothing unusual about these big numbers—except that Cemex, the world's third-biggest cement-maker, comes from Mexico, while its target, RMC, is British. Queen Victoria, whose subjects built or financed much of Latin America's infant infrastructure, would not have been amused.

In contrast, RMC's mainly British shareholders are laughing. They have been offered a fat 43% premium above the pre-bid share price to get out of a dismal underperformer: RMC, whose main business is ready-mixed concrete rather than cement, operates mainly in slow-growing Europe, not least extra-slow Germany, where for years it has burned its fingers (and twice had them rapped by antitrust authorities). It is Britain's biggest cement-maker, but its world turnover, maybe $7.7 billion this year, is smaller, in sterling terms, than in 1999; and its likely profit, estimated by London brokers at $325m, is far smaller.

Why should Cemex offer $4.1 billion; $5.8 billion if you add in RMC's debt? True, Cemex is to borrow all that $5.8 billion—but that means more than doubling its own debt, quite a change of tone from a company which on September 12th told the markets it expected to cut its debt by $900m in the first nine months of 2004. Little wonder the ratings agencies and stockmarkets were less than pleased.

Cemex's own answer is that the deal will give it a solid cashflow in western Europe (where it now operates only in Spain), opportunities in eastern Europe, and some integration of the two companies' operations in the United States, where both get about a quarter of their sales. And, as Cemex courteously does not say but analysts do, it could teach RMC a thing or several about managing cement.

The deeper answer is that, having more than trebled turnover and doubled profits from 1992 to a peak in 2001, Lorenzo Zambrano, Cemex's boss since 1985, has seen two years of stagnant turnover and far lower profits. This year's figures will be better, notably in the United States, but neither Mexico—still a third of the business—nor the rest of Latin America today offers much growth. Cemex is already active in Asia, but Europe lies almost untouched. And high-volume, low-value cement is not the sort of stuff in which you can expand just by exporting. If you have ambitions abroad, you set up there.

Ambition is not something which Mr Zambrano lacks. Cemex was originally a family business begun by his grandfather, but he has made it into multinational. Among many other purchases, in 1992 he bought Spain's two biggest cement firms, and in 2000, for $2.8 billion, Houston-based Southdown Cement. And he has connections to match: a seat on the board of IBM, membership of advisory boards at Citigroup and DaimlerChrysler, and one of the six deputy chairmanships of the Trilateral Commission, the body of grandees which in anti-globalist demonology supposedly runs the planet.

Mr Zambrano's ambitions do not reach that high. But if the deal goes through, as few doubt that it will, he will be running an outfit whose $15 billion-plus turnover will put it head and shoulders above any other Mexican company, and, in cement, not far short of Switzerland's Holcim, the number two after French giant Lafarge.

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Vodafone

Not so big in Japan

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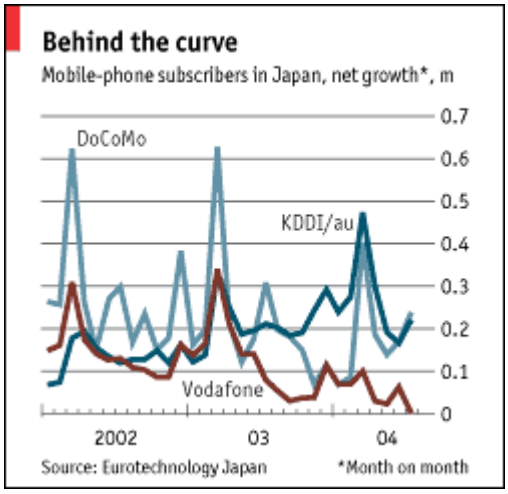
Can the world's largest mobile operator overcome its Japanese hang-up?



THE future, noted William Gibson, a science-fiction writer, is already here—it is just unevenly distributed. Japan's mobile-phone industry, for example, is generally agreed to be a year or two ahead of the rest of the world (with the exception of South Korea, which is equally advanced). That is why Vodafone, the world's biggest mobile operator, took control of J-Phone, Japan's third-largest mobile operator, in 2001: to see into the industry's future.

But J-Phone (renamed Vodafone last year) has now fallen far behind its bigger rivals, NTT DoCoMo and KDDI. J-Phone's market share, which increased continuously for more than five years, started to decline in the summer of 2003, as its subscriber growth-rate plunged (see chart). This was not simply due to the name change, notes Gerhard Fasol of Eurotechnology Japan, a Tokyo-based consultancy, since the decline began before the rebranding. Instead, the cause is Vodafone's ambitious strategy, a daring step away from the Japanese mobile industry's usual way of doing things.

Japan's mobile industry is unlike any other, due to the unusual power of the country's mobile operators. Each one works closely with handset-makers, specifying features in great detail and selling the handsets under its own brand. This makes it easy to integrate the handsets with new services, such as photo-messaging or video-calling. The proprietary handsets cannot be transferred from one network to another, which encourages customer loyalty, but makes international roaming almost impossible. This whole set-up is the antithesis of the European model, where most subscribers feel more loyalty to handset-makers than to operators, handsets can be moved easily between networks and roaming is easy—but new services take longer to appear, since handset-makers and operators must agree on standards first. (The American model sits somewhere in the middle.)

Since taking over J-Phone, Vodafone has done a very good job of appropriating the best bits of the Japanese model and applying them in other markets. Its Vodafone live! data service, which is closely tied to Vodafone-specific handsets, is a carbon copy of the successful mobile-data services pioneered in Japan by DoCoMo. But Vodafone has, so far, been far less successful in transferring aspects of the European model to Japan.

It is trying to do so in two main ways. First, and most important, it is moving away from proprietary, operator-specific technology, and towards the standards used elsewhere in the world. In particular, the third-generation (3G) networks and handsets Vodafone is rolling out in Japan use W-CDMA, the technology being adopted in Europe. The company also intends to sell more subscriptions through its own chain of shops, as it does in Europe, rather than through third parties.

In the short term, all of this is proving very painful. W-CDMA handsets are now becoming widely available—Vodafone announced a range of new models last week—but a year or two later than expected. As a result, Vodafone has been unable to compete as Japan switches to 3G. KDDI has already migrated the majority of its customers to 3G technology; DoCoMo has moved about 10% of its customers, and is now signing up 3G subscribers faster than 2G ones. Vodafone, by contrast, has switched a mere 1% of subscribers to 3G, and is losing subscribers to its rivals. At the same time, it is overhauling its billing systems and reorganising its distribution, which means renegotiating contracts with existing retailers. At Vodafone's annual investors' conference this week, the Japanese management team explained that these

changes are going according to plan, but will take time.

In the long run, however, this strategy could have substantial benefits. Using standards-based handsets will give Vodafone economies of scale, since it will be able to buy handsets in large quantities and will no longer require special Japan-specific models. The company can also gain better terms from handset-makers by offering them access to foreign markets: in Europe, it sells lots of handsets made by Sharp, for example. And the ability to roam between Japan and other countries should appeal to corporate customers. Meanwhile, selling phones through its own shops will make it harder for retailers to play operators off against each other, notes Damien Chew, an analyst at ING, and should keep customers more loyal.

The big test for Vodafone's new Japanese boss, Shiro Tsuda, a former DoCoMo executive who takes over in December, will come next March. Japanese retail sales are highly seasonal, with a big peak in March. Mobile operators launch new handsets around this time in order to attract new customers. Last March, DoCoMo and KDDI prospered, but Vodafone did not; next March will reveal whether Vodafone, which has done well when applying Japanese ideas in Europe, can also benefit from applying European ideas in Japan.

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Pharmaceuticals

Poor markets, rich rewards

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Why drugmakers should do more for developing countries

Get article background

PUTTING profits before patients is not what many pharmaceutical companies would like to be known for. But that is exactly the reputation many of them earned in 2001, when 39 firms sued the South African government over changes to its patent laws to ease the supply of affordable anti-HIV medicines.

Since then, the industry has been scrambling to redeem its tarnished reputation. Many firms have agreed to make some existing drugs more accessible to developing countries; a few, such as GlaxoSmithKline and Novartis, are trying to develop new drugs for diseases which mainly afflict poor countries.

Another way forward is “public-private-partnerships”, in which drug companies contribute molecules, manpower and machines to not-for-profit groups which co-ordinate product development and are backed by private foundations or governments. There are now almost 20 of these groups working on drugs, vaccines and diagnostics, according to a report recently published by the Initiative on Public-Private Partnerships for Health, a policy group based in Geneva.

Progress has been good so far, says Roy Widdus, manager of the initiative. Some of the partnerships, such as the Medicines for Malaria Venture and the International AIDS Vaccine Initiative, have a number of products in clinical trials. Just as important, though, is the business rigour these not-for-profit groups are developing, including the need to cancel struggling projects early. Although more firms are taking an interest in such partnerships, Mr Widdus says still more needs to be done to involve them, as well as finding new sources of finance: according to the report, today's partnerships could face a funding gap of at least $1.2 billion by 2007.

That negative attitudes towards the drug industry persist worries the Pharmaceutical Shareowners Group, which represents some big institutional investors. In a recent report it said business, and therefore shareholder value, could be hurt by governments in poor countries becoming less sympathetic to industry demands for strong patent protection and governments in rich countries becoming less amenable to arguments for higher prices.

The report concludes that most firms still treat drugs for the poor as philanthropy rather than as a business, and have yet to devote enough senior managers to the task. It wants firms to do a better job reporting their activities and to take a more business-like approach to analysing how their actions affect other corporate interests, such as relationships with regulators and staff recruitment. After all, most people who would consider working for a drug firm would want it to be profitable, and yet would not be comfortable with the motto “profits before patients”.

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Face value

The oil man in the jump seat

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How Glenn Tilton is struggling to stop United Airlines crashing

Landov

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AS OIL prices climbed, touching $50 a barrel this week, adding to the cost burden dragging down United Airlines, America's second-biggest carrier, Glenn Tilton could be forgiven a whiff of nostalgia for his days as chief executive of Texaco. When growing up in Brazil, where his father worked for America's Central Intelligence Agency, he was impressed by the glamorous lifestyle of a family friend who ran the Latin American end of Pan Am. But warned off airlines by this executive, the young Mr Tilton embarked instead on a 30-year career in the oil business.

After the merger of Texaco with Chevron, he finally got his chance to get into the airline business as boss of United. Just three months later, in December 2002, he was forced to put the airline into Chapter 11 bankruptcy after the federal government refused a loan guarantee. Since the airline's third, and final, request for a loan guarantee was turned down last June, United's struggles have become more desperate and complicated. It had planned to emerge from bankruptcy protection with its finances reconstructed early this year. Mr Tilton now pins his hopes on avoiding liquidation and emerging from bankruptcy protection next spring, provided he can put together a business plan in the next three months that is persuasive enough to attract outside investors, such as adventurous private-equity funds.

The turbulence does not help. Last week, a federal bankruptcy judge sided with the unions and refused to go along, without further debate, with the airline's argument that its pension fund is in better shape than previously estimated. United claimed a shortfall of only $2.7 billion, compared with a calculation of $8.3 billion made by the Pension Benefit Guaranty Corporation (PBGC), the federal body that picks up the pieces when company schemes fold in mature industries like steel, textiles and (now, it seems) airlines. United stopped paying into its pension fund this summer and is considering shutting it altogether, for which it would need court approval. This would leave the PBGC to pick up the liabilities. Closing the pension fund would also save the airline $4 billion over the next four years.

Pensions and fuel prices are now crucial issues for America's airlines. This follows three bruising years. The terrorist attacks on America, the collapse of the dotcom bubble, the Iraq war and the SARS epidemic have all taken a toll. Passenger numbers have bounced back, but revenues are still lagging, not least because low-cost competitors have forced down fares.

United is not alone. US Airways has flown back into Chapter 11 for the second time in two years, and Delta Air Lines could follow it. So perilous is Delta's position that its senior pilots have been rushing for the emergency exits, determined to draw their pensions before the financial axe falls. Delta risked running short of pilots until this week, when it arranged to hire back retired staff on a contract basis and to cut some salaries by 10%.

Mr Tilton defends the industry's frequent recourse to the bankruptcy courts. “So long as we have to fall under the scope of the Railway Labour Act of 1926,” he said, “Chapter 11 is the only way to gain leverage with the unions.” The said act is a federal law that was widened to cover airlines in 1936: in return for employees forgoing the right to stage wildcat strikes, employers are obliged to negotiate with unions. While this does make things tricky, it is disingenuous for airline managers to pin all the blame on an antique labour-relations law. After all, successful carriers such as Southwest Airlines are also governed by the law, and yet have good relations with their employees.

Nevertheless, there is no denying that United itself is an experiment in labour relations that has failed. When the airline faced a financial crisis a decade ago, employees surrendered pay for shares and boardroom seats, only to fight to get their pay restored when a late-1990s boom temporarily gave the airline a semblance of financial health. So Mr Tilton inherited overblown costs, over-capacity, over-rigid working practices and corporate-governance considered by many to be a joke.

Cuts and cuts

Until the pension crisis came to a head, Mr Tilton had been doing rather well. He had persuaded unions representing pilots, cabin crews and ground staff to take swingeing pay and benefits cuts, and to reform their rigid labour practices. Of the $5 billion in annual savings he has wrung out of the carrier, half has come from staff. But pushed by the extra cost of fuel, he now needs another $1 billion in cuts, which could involve the loss of a further 6,000 jobs on top of the 30,000 that have already gone, which represented one third of the workforce. He has put workers and management on a similar bonus scheme. This pays out quarterly if performance targets, such as punctuality, are met. United has done better in running its network than any of its rivals since the scheme was introduced, and its load factor of 84% (the industry's highest) reflects this.

Mr Tilton has also reshaped the airline's network drastically, launching a low-cost subsidiary, called Ted, to serve holiday destinations such as Florida and Mexico. Small, cheap regional jets are now used instead of bigger planes to feed United's big hubs at Chicago and Denver. A new premium coast-to-coast service has been launched. He is also counting on a recovery in international services, where United is boosted by being a key member of a global alliance of airlines called Star.

But whether these reforms will be enough to save the airline could yet depend on decisions by the bankruptcy court and creditors. United has to persuade the court that it has a reasonable case for ditching its pension obligations in order to stay aloft. The unions are hostile and suspicious, and the PBGC—with an existing $11.2 billion deficit—is worried about having to take on perhaps another $8.5 billion of liabilities from United and US Airways. Mr Tilton's bumpy ride is far from over.

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Gambling goes global

All bets are on

Sep 30th 2004 | LAS VEGAS
From The Economist print edition

Alamy

As it becomes steadily more respectable, the gambling industry is trying to become a thriving global business

AMERICA did not invent gambling: but with its casinos, rightly celebrated for their ever more gloriously grotesque architectural excesses, it perfected an especially effective way of separating willing consumers from their cash. After a decade of spectacular financial growth, the industry there is trying to consolidate. And not content with dominating gambling in their home market, America's biggest firms are already planning to export their methods around the world.

Helping them is gambling's new-found respectability, as well as governments' increasing interest in deregulating businesses that have typically been tightly controlled. But the big American companies also face a threat. Internet gambling has been growing with astonishing speed, even though it remains illegal for American consumers. This is a double-edged sword for the big firms. The ban on internet betting at home protects their profits in so far as American consumers can be stopped from betting in cyberspace. But far better protection would come from offering the service and using their superior brands to mop up even more business. And unless they can grab a share of the cyber-betting outside America, their expansion might fail to produce the spectacular returns on which they are counting.

The global capital of gambling is Las Vegas and a visit there reveals how the industry has evolved. These days fruit machines and roulette tables seem almost like an after-thought. Tourists take their pick of attractions—from strolls through ersatz versions of ancient Rome, medieval England or old New York—in the form of massive themed hotels. Luxury-goods shops abound. Some casinos get less than half of their revenues directly from betting.

Gambling has been Las Vegas's money-spinner since Bugsy Siegel built the first casino in the 1940s. An attempt in the 1990s to attract vacationing families by installing rollercoasters, crèches and Disneyland-style attractions failed badly. Now, Las Vegas pitches itself to adults. The latest draw is the “ultralounge”, a bid to revive the lounge-lizard culture of the 1960s.

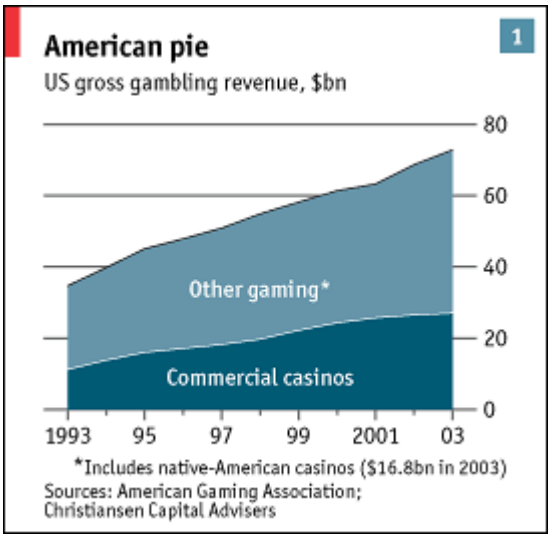
After September 11th, the city was badly hit by a drop in tourism. But it rebounded strongly, capturing a growing share of America's tourism and convention trade. And it increasingly offers high, as well as low, culture. The Bellagio's art gallery, just steps from the slot machines, is currently showing Monet paintings from Boston's Museum of Fine Arts. The Guggenheim Museum has an annexe at the Venetian. Steven Wynn, who built the Mirage and Bellagio hotels, is likely to hang his Picassos and Modiglianis in a new development due to open next spring.

Las Vegas achieved iconic status by offering a mild taste of naughtiness in a country that often lacks it. The slogan for a new ad campaign sums it up: “What happens in Vegas, stays in Vegas.” Money certainly

stays. Casino gambling provided nearly $800m in tax payments to the state of Nevada last year.

Other states have followed Nevada's lead: gambling in America has more than doubled over the past decade. Turnover in casinos grew from $11.2 billion in 1993 to $27 billion last year. Turnover from all forms of gambling reached almost $73 billion last year (see chart 1).

Recently gambling has even taken on a sense of cool, as poker tournaments featuring Hollywood stars have been some of the highest-rated programmes on cable television. In August, WPT Enterprises, which runs the World Poker Tour, successfully floated on the NASDAQ stockmarket.



But bigger companies control the industry. A recent brace of mergers will, if antitrust regulators allow, create two giants. In early June MGM Mirage—itself the product of a merger in 2000 between Kirk Kirkorian's MGM Grand and Mr Wynn's Mirage Resorts—bid for Mandalay Resort Group, a rival. Together, the two firms control nearly half the hotel rooms in Las Vegas. In July Harrah's Entertainment, a casino chain catering more for the mass market, made a bid for Caesars Entertainment. The latter has one of the best-known brands in the industry, but has been lumbered with debt taken on to finance a long-overdue overhaul of its ageing Las Vegas resort, Caesars Palace.

If regulators give the nod, both of the two big firms will have powerful capital bases from which to expand in Las Vegas and beyond. On September 27th Caesars and Harrah's announced that they had each sold two of their casinos for a total of $1.24 billion. The deal was part of their efforts to convince regulators to approve their merger.

Casinos can be found in most countries, but the mass-market variety was pioneered in America. Contemporary attitudes towards gambling were set in the 1960s when the state of New Hampshire launched a lottery and brought in far more money than anyone had predicted. Today, 39 American states run lotteries, while 34 allow casinos. Only Hawaii and Utah ban gambling altogether. Moreover, states are still trying to join the party. The District of Columbia, the nation's capital, is considering allowing slot machines, and Pennsylvania wants to put them at its racecourses. California has just entered into a “compact”, or treaty, with a native-American tribe near San Francisco to take a cut of what is likely to become one of the country's biggest casinos. Its projected $100m a year in taxes will help plug the state's yawning deficit.

The pips are squeaking

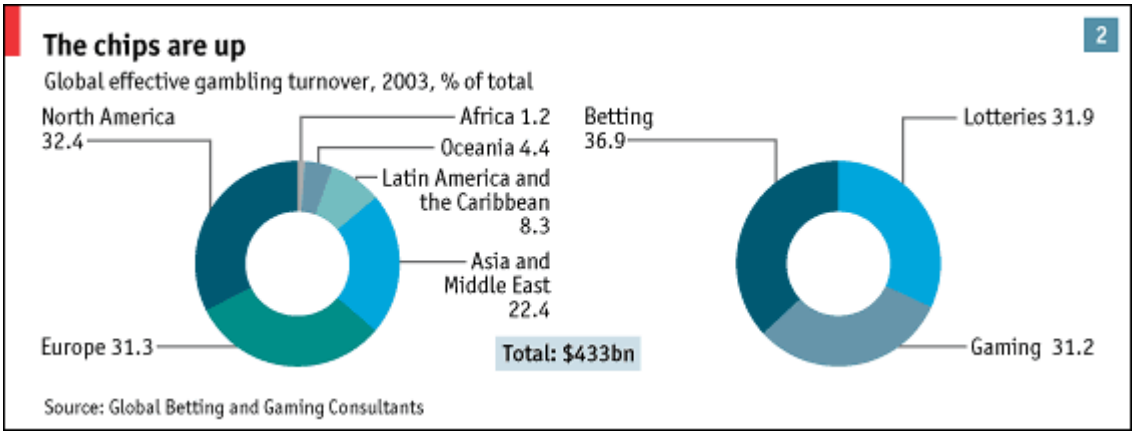
Success for gambling in America has bred challenges. The first is that several of the states that so welcomed casino operators are now squeezing them through higher taxes. That has been increasingly true as the states have begun to face up to big fiscal deficits created in recent years. In Illinois, top-rate taxes on casino profits now run at 70%. Michigan recently increased its tax rate from 18% to 24%.

The second threat is of saturation. Most Americans who want to gamble in a modern casino can do so within just a few hours' drive from home. The North American market is “mature”, reckons MGM Mirage, and Las Vegas is a case in point—analysts have long worried about over-supply there.

With higher taxes and a saturated home market, it is small wonder that American operators are looking hungrily at opportunities overseas. They are encouraged by the fact that other countries are preparing to follow America's lead. Britain is making some of the biggest strides towards freer gambling. It has already liberalised its betting laws by reducing taxes on sports and horse-racing wagers. It is also in the process of finalising a bill to allow Las Vegas-style casino resorts in its big cities. And the country also wants to become home to fast-growing internet-gambling companies, now typically based offshore.

In Asia, Macau is inviting foreign competition for its dreary, locally owned casinos, and has already given licences to three Las Vegas companies. Mr Wynn is planning one. Sheldon Adelson, founder of Las Vegas Sands, whose Venetian Resort offers as good an imitation of the Bridge of Sighs as one is likely to find in America, opened Sands Macau earlier this year. More gambling licences are likely to be issued in future. And other Asian countries, from Singapore to Japan, are looking to emulate Macau.

Why are so many governments loosening the laws that have long constrained one of the world's oldest businesses? Gambling is an especially attractive service to tax. There is huge demand for it, and punters are mostly insensitive to price. Except for the small number truly addicted to gambling, people gamble voluntarily, but pay taxes only unwillingly. Introducing new forms of gambling—allowing, say, a lottery where sports betting is available—can often increase the overall demand for both types of punts.



Indeed, although casinos are the most visible part of the gambling industry, they are not the most important. Globally, gambling operating revenues—broadly the amount staked (minus the winnings returned to punters in the case of casino games and machines)—were $433 billion last year according to Global Betting and Gaming Consultants. Lotteries, which are mostly state sponsored, are the biggest single sector. Wagering on horse racing is close behind, although growing weakly. However, for gambling businesses, the trick is to follow punters into new markets that can grow. The biggest growth rates are in casino-style betting outside America and, increasingly, in cyberspace.

A baize patchwork

Gambling is also a big business in Europe, but there it is fragmented and disorganised, characterised mainly by a few fruit machines in bars and amusement arcades. Monaco is an upmarket haven for rich punters. France has 160 “casinos”, but these are mostly small clubs away from the big cities. Europe's biggest casino is now in Estoril, Portugal. Each year Europe's gamblers place bets equivalent to 5% of the continent's GDP, almost one-third of which stays in the industry's pockets.

Britain's casino business is small. In London, most casinos are “clubs” attached to hotels. Punters must wait 24 hours before becoming a member. The poshest places, such as Aspinall's and the Ritz, are said to depend on a few rich foreigners for most of their turnover.

If its long-anticipated gambling bill becomes law next year, as seems likely, Britain's gambling industry will be shaken up. Plans for casinos in places such as Blackpool, a faded Victorian-era resort, as well as in city centres from Birmingham to Glasgow, are already afoot. London's Millennium Dome has been mooted as the site of a casino to be built by Sol Kerzner, founder of South Africa's Sun City.

But the bonanza in Britain may not be as big as some hope. The government has pulled back from a full-scale free-for-all. It wants to limit the number of big-win slot machines—thanks to the terrible odds that they offer, these provide fat profits to operators. The government has two worries. The first is that such

slot machines are highly addictive. The second is that their widespread introduction in new casinos would threaten the businesses of existing smaller operators, which rely on machines that have limited payouts. Despite the government's hesitations, MGM Mirage thinks that around 10% of its global profits could come from Britain by the end of the decade, up from almost nothing today.

Other European gambling Meccas are preparing to compete. Monaco has discussed the possibility of building a new (offshore) casino resort with Mr Wynn. Casinos in Nice have spruced themselves up. Their willingness to do so is not entirely unconnected to a factor that is affecting the entire industry and that threatens America's long-term dominance: the rise of internet gambling.

More bets than butts?

Arguably, only the pornography business is as well-suited to cyberspace as gambling. There are already around 1,500 gambling websites, offering everything from casino games, sports betting and punts on America's presidential election. Up from $1 billion in 1999, the turnover of internet gambling is poised to rise to $10 billion by the end of this decade, according to a recent report sponsored by the British government. Leighton Vaughan Williams, director of the Betting Research Unit at Nottingham Trent University, says that governments have realised that maintaining domestic prohibitions on gambling only loses tax revenues as consumers use internet services based elsewhere.

A new type of online gambling, betting exchanges, has done especially well. Unlike traditional bookmakers, which bear the risk of balancing their own odds to earn a profit, these companies, led by Britain's Betfair, match gambles between two individuals, thus keeping none of the risk themselves. But their success has created controversy. Punters on betting exchanges have the ability to “lay” odds, which allows them to profit from a losing horse or football team. Recently, British police rounded up dozens of suspects in a race-fixing investigation. Ironically, the transaction trail provided by websites is a help to those trying to catch fraudsters.

The biggest challenge to the online gambling business is that it is still illegal in America, even though Americans already bet millions of dollars in cyberspace. Online betting firms have based themselves offshore, in places as far-flung as Antigua, Gibraltar and Costa Rica. The American government tries to interfere by sending out regulatory feelers to such places. Recently, however, Antigua won a WTO case by arguing that America's law interfered with the Caribbean island's freedom to trade. Britain has a declared goal of becoming one of the leading locations for internet-gambling businesses, using low gambling-tax rates and effective regulation as lures for site operators. One online bookmaker, betonsports, recently listed its shares in London.

Another technology that has quickly made a mark allows gambling via video screens. New machines make mechanical one-armed bandits seem old hat, but that has spurred innovation. International Game Technology, one of the biggest makers of the threatened machines, is crafting new ways to keep the coins coming in. Slot machines increasingly offer access to huge jackpot pools spread over a whole country. The firm develops new themes, working in much the same way as a film studio.

In Europe, where machines in smaller entertainment centres are common, video gambling is a challenge. Eduardo Antoja, of Euromat, a fruit-machine trade association, says that video games have made young people less attracted to traditional casino machines. He says that the industry will begin to offer more multi-player games and social games to fend off the threat faced by a big wave of new casinos. The European Union is trying to harmonise its laws, but that will take years.

Land-based gambling has more to worry about than just the internet. Sky, a British satellite-television provider, saw a huge increase to 12m in the bets placed through its interactive handsets during its 2002-03 financial year and is relying on betting to help make up for the slowdown of its main business. Mobile phones are likely to be the next new vehicle for betting. 3G services will allow casino-gambling games with attractive graphics and colour. Before too long, almost everyone will be able to have a taste of Las Vegas at the press of a button.

Or will they? As outlets multiply, so do concerns about the negative effects of easy access to gambling. The internet has stoked anxieties that children will be targeted. According to GamCare (a British “responsible gambling” organisation), only seven of 37 gambling websites recently tested stopped a 16-year-old from registering online. Thanks to the increasing availability of debit cards to children as young as 11, vetting the age of online punters is obviously not easy.

The spread of traditional land-based casinos also inevitably causes controversy. There is some evidence that rates of suicide, bankruptcy and domestic violence all rise when casinos arrive in a city. However, a study in 1999 by an American commission set up to assess the impact of gambling found little evidence of any rise in these social ills when casino gambling is legalised. One reason is that it is hard to separate the impact of other factors, such as the state of the economy.

A harder perception to fight is that casinos, like lotteries, exploit the poor. In recent years they have been launched most often in the poorer bits of America. In the 1990s the fading rust-belt cities just south of Chicago brought in riverboats to create jobs that offset some of those lost by the ailing steel industry. To an extent that has worked: new jobs have certainly come. However, it is hard to tell how many people end up paying their wages back in the form of gambling losses.

Alamy

Lucky for some

Not so cheap thrills

Perhaps the biggest controversy attaches to “rapid-play” machines that give punters the chance to chase their losses, often using credit cards to rack up surprising debts in a matter of minutes. Australia has one of the highest rates of problem gamblers in the world, at around 2.2% of the adult population. That is due in part to a proliferation of gambling in pubs and social clubs, with a heavy emphasis on rapid-play fruit machines. Other countries are likely to try to limit the machines' spread.

But America's gambling industry is not exactly quaking in its boots. Years of learning how to defend itself at home have turned it into a formidable lobbying force. It points out, for example, that just over 1% of the adult population in any country will be prone to gambling addiction. It has donated millions to addiction clinics and other causes.

The effort has been so successful that the industry has largely shed its once dodgy reputation. But can it repeat its domestic success as it goes global? Deregulation favours it, as do the casino companies' obvious business skills. However, competition and a proliferation of outlets will drive down returns. How the big companies respond to that will decide their future more than anything else. In the short term, they will concentrate on establishing themselves and their brands using terrestrial casino outlets beyond America. But in time, further consolidation involving the internet seems inevitable. The question is how long new entrants have before the next shake-up begins. Odds, anyone?

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Corporate America

Excess optimism

Sep 30th 2004
From The Economist print edition

American companies' earnings are under pressure from a rising oil price. This is bad news, because American companies' prospects aren't that healthy anyway

WHILE keenly aware of the instability of Nigeria and the precariousness of its oil supplies, few in the oil industry, let alone anyone outside it, are likely to have heard of the Niger Delta People's Volunteer Force. They have now. News that this obscure faction had told oil companies to stop production in Nigeria, the world's ninth-biggest oil producer, and that, improbably, it was about to wage all-out war on the state, was enough to send oil briefly over $50 a barrel this week. The price of crude has now risen by more than half this year—and the sharp rise in the price of oil for future delivery suggests that oil users think it likely to stay high. That will probably start to prove a drag not just on the American economy as a whole, the biggest consumer of oil, but also its companies, which in recent years had seemed to have remade themselves into profit machines.

Low yields on government debt suggest that bond investors, at least, think that a rising oil price, among other things, will slow economic growth. Yet with a few exceptions, equity investors seem to think that companies will be unaffected: American shares have fallen only a bit this year; indeed, they are still valued as though American companies will take this latest blow in their stride. That looks unlikely. Straws in the wind, perhaps, but on September 29th the Bureau of Economic Analysis (BEA) announced that corporate profits in America fell by 0.7%, after tax, in the second quarter compared with the first.

The worst-hit industries are well known to the stockmarket, and for them the rising oil price is just one more burden. Airlines are in a dreadful hole. United Airlines and US Airways are already in bankruptcy; Delta is teetering on the edge. So far this year, shares in airlines have fallen by 23%, and the International Air Transport Association said on September 27th that, partly because of higher fuel costs, airlines around the world would lose up to $4 billion this year.

Car companies, too, have been hit hard. This is partly because the high oil price has raised their manufacturing costs, but also because their most profitable lines have been sport-utility vehicles, which guzzle even more gas than the rest. Shares in carmakers are down by over a fifth this year.

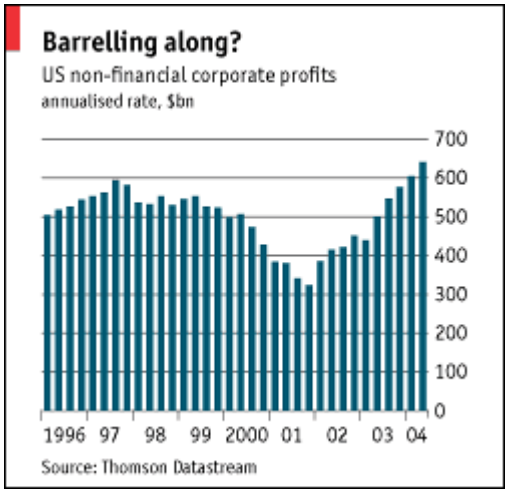
But autos and transportation account for only some $200 billion of the $10 trillion capitalisation of the American stockmarket. The puzzle is why investors appear so unfazed by prospects for other firms. One reason, of course, is that the profits of many of them—financial firms, for example—appear unaffected by rising oil prices. And financial firms make up 40% at least of all corporate profits, and probably more like

half if quasi-financial companies such as General Electric are taken into account. (In 1980, by comparison, the figure was a mere 6%.)

In fact, suggests Jim Bianco, who runs an eponymous research firm, surging oil prices are very likely to have an effect on financial firms' profits. The single most important determinant of these is the steepness of the yield curve—the difference between short- and long-term rates. When it is steep, financial folk rake in profits. In the past few years it has been very steep indeed. Last year, when it was at its steepest, banks made more money than ever.

Now the yield curve is flattening for reasons that are connected with the oil price. At the same time that the Federal Reserve is putting short-term rates up to more normal levels, the fear of bond investors that the rising oil price will contribute to a slowing economy has sent bond prices up as well, reducing long-term yields and flattening the yield curve. Since the yield curve is still very steep by historical standards, it is likely to flatten further.

Profits elsewhere seem to have held up admirably. As the chart on the previous page shows, since 2001 profits for non-financials have soared, though only earlier this year did they exceed the level they reached in 1997. But growth is slowing. In the second quarter of last year pre-tax profits were 14% higher than the quarter before. But in the latest BEA survey, they rose by only 6%.



Andrew Smithers, a stockmarket consultant not known for his bullish views, thinks profits will be hit as corporate cashflow falters. Both consumers and the government are so indebted that they cannot save less and spend more. So a slowing economy and higher oil prices cannot mean anything other than lower profits. “There are no circumstances under which rising oil prices do not hit profits,” he says.

Even bullish analysts who think that the rise in the oil price will have little effect on profits believe that profits will weaken nevertheless. Ajay Kapur, a strategist at Smith Barney, a brokerage firm, thinks that they will rise by 19.3% this year but only by 6% next year.

Flattening profits should draw attention to companies' still-suspect finances. Corporate-debt markets have risen strongly, mainly because so many investors have assumed that companies were using those bumper profits to pay off debt and repair balance sheets ravaged by the excesses of the late 1990s. In the round, however, companies have done very little to pay off debts. Certainly, credit-rating agencies, which are supposed to notice such things, are unimpressed. The average rating awarded by Moody's has fallen by a notch over the past three years, from investment grade to junk. This year downgrades have outnumbered upgrades.

It is true that some of this trend is explained by lowly rated companies coming to the market for the first time, but the effect of this development is small because so many American firms already issue bonds. And in a sample of 175 big firms studied earlier this year by CreditSights, a research firm, total debts were still 40% higher than they were in 1999.

So if companies have not been investing much, what have they done with all the money? Given it back to shareholders by various means. Share buybacks are at their highest in some 20 years. In the second quarter, companies repurchased shares at an annual rate of $159.5 billion, according to Mr Smithers.

Alas, in the same quarter, American companies generated a financial deficit rather than a financial surplus. For the first time since the first quarter of last year, in other words, investment exceeded profits. Although the deficit was quite small, it is likely to get larger if profits and profit margins fall further. That seems very likely. Consumers are too indebted, the trade deficit continues to widen, tax breaks are to be scrapped and the price of oil is rising. The profits that people are most likely to hear about are those of gloom.

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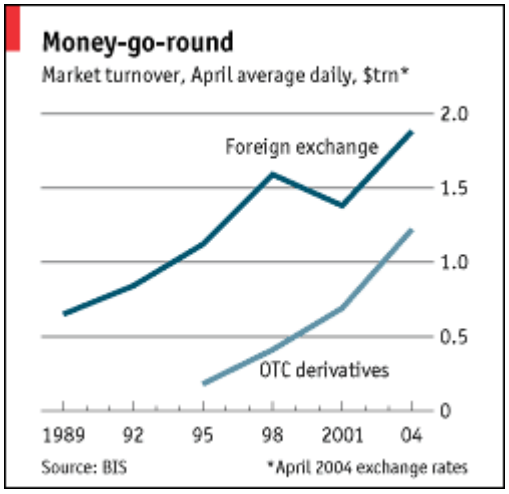
Currency trading

The buck doesn't stop here

Sep 30th 2004
From The Economist print edition

Forex trading is brisk, but no rampage



"HIGHWAYMEN of the global economy", rise up. Despite the contempt heaped on them by certain politicians around the world (including Malaysia's former prime minister, Mahathir Mohamad, quoted above), currency speculators have had a bumper time in the past three years. In April, the Bank for International Settlements took a snapshot of "traditional" currency markets as well as derivatives exchanges for currencies and interest rates. Its report, published on September 28th, says that growth in both continues apace.

The daily turnover of derivatives markets was $1.2 trillion, 77% more than three years before, and almost seven times as much as in 1995. Though breathtaking, this ought not to be surprising, with speculators looking for a better game and businesses growing increasingly sophisticated at hedging. The fall in the dollar helped too, as companies and banks rushed to hedge.

Trade in foreign-exchange derivatives has doubled since 2001. But interest-rate derivatives far outstrip them: the total traded daily is just over $1 trillion. Jim O'Neill, chief global economist at Goldman Sachs, says that easy monetary policy was a prime reason: the Federal Reserve's series of cuts starting in 2001, from 6½% to 1%, was "an enormous stimulus for the interest-rates business."

The report also found that turnover in "traditional" foreign-exchange instruments, such as spot transactions or swaps, surged to a headline-grabbing $1.9 trillion a day. But long-term growth has been more a trot than a gallop. In 1999, the introduction of the euro abolished several currencies, and sharply reduced volume for a couple of years. The bursting of the tech bubble also decreased activity. So even though trading has soared by 36% at constant exchange rates since 2001, it is only 18% higher than in 1998.

The real forces behind growth in forex are the huge hedge funds that have been piling back into the market. But they are fickle players. Nick Bennenbroek, senior currency economist at Brown Brothers Harriman in New York, says that the continuing climb of the global economy should keep currency markets purring along, while a move in the dollar—up or down—would benefit derivative players. But if interest rates rise more slowly than they were cut, and the dollar is stable, speculators may seek new pastures—just possibly, to the irritation of developing countries' leaders.

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Fannie Mae

About time

Sep 30th 2004 | NEW YORK
From The Economist print edition

Now it's Fannie's turn to be scrubbed

ACCOUNTING practices at Fannie Mae had long drawn criticism, but that never seemed to matter. The regulator of America's giant mortgage company, the Office of Federal Housing Enterprise Oversight (OFHEO), was known by few and considered relevant by even fewer. All that has changed since the publication of a report by OFHEO on September 22nd.

The report accused Fannie Mae of pervasive misapplications of generally accepted accounting rules. These errors were “reinforced by management”. OFHEO concluded that the company's past financial results may not be valid, and that its capital is probably overstated. Accounting policies were aimed at making Fannie Mae's earnings appear more stable than they truly were: a “cookie jar reserve” of unrecognised income and expenses was maintained to smooth out returns. Results may even have been manipulated to push up managers' bonuses. Fannie Mae's shares dropped after the report's release, falling by 15% in three days before stabilising.

The substance of the report concerns two accounting issues. The first affects Fannie Mae's executives more than its bottom line. In 1998, following the turbulence from the Russian financial crisis, interest rates in America fell, prompting many Americans to refinance their mortgages. This cost Fannie Mae $400m. There are many legitimate ways to treat this loss in a company's accounts, all of which spread the loss over a period that captures the span of the economic damage. It seems that Fannie Mae used another method, expensing $200m immediately and amortising the rest—in effect, treating it like capital expenditure. That split was just enough to trigger provisions for maximum bonuses in the contracts of the company's senior executives.

The second problem is more costly to the company. It stems from complex choices made in recognising billions of dollars of losses on derivatives. The bulk of these were recorded in its regular accounts, but not in its income statements, nor in its regulatory filings. There are legitimate arguments for this treatment, but OFHEO did not agree with Fannie Mae's approach. The implications go beyond merely restating the numbers. Capital has been lost and must ultimately be replaced.

On September 27th, Fannie Mae made several concessions. Billions of dollars in new capital will be raised, supervision increased and managerial authority reorganised. However, OFHEO's conclusions are serious enough to have sparked a criminal investigation, into possible accounting fraud, by the Department of Justice. The Securities and Exchange Commission has begun an informal inquiry into Fannie Mae's accounts. And the first of what will certainly be many shareholder suits has been filed.

Both Standard & Poor's and Moody's, top credit-rating agencies, are considering downgrades of Fannie Mae's subordinated debt and preferred stock: unlike the company's bonds, these are not perceived by the markets to enjoy a government guarantee. Congress, where Fannie Mae and its sibling, Freddie Mac, have many friends and where regulatory reform has been blocked repeatedly, has belatedly begun asking questions. It will hold hearings on the two mortgage giants next week.

Meanwhile, Fannie Mae has some difficult decisions to make. Its board, contradicting its earlier line, has acknowledged discussing an earnings restatement. Within the next nine months, the company must work out how to raise new capital. None of the standard methods looks attractive: a dividend cut will not be popular; nor, in mid-crisis, will an equity offering. Alternatively, Fannie Mae could unload assets. But selling some mortgages from its vast portfolio might disrupt the mortgage market—not to mention denting Fannie Mae's returns.

At least Fannie Mae can say it is not alone. Last year Freddie Mac, the other American mortgage giant,

was under siege for accounting problems that emerged when it was forced to replace Arthur Andersen as its auditor. The replacement, PricewaterhouseCoopers, clearly took its task seriously. Freddie Mac's senior executives were soon gone.

Fannie Mae was thought to be better at this sort of stuff. For a year or more, ever since regulators started looking into the company, there have been suspicions that it is not. Now OFHEO's report has shown that those suspicions were justified—and the only surprise is that Fannie Mae's top executives have not yet gone the way of Freddie Mac's.

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Debt relief

Clean slate

Sep 30th 2004 | WASHINGTON, DC
From The Economist print edition

Should poor countries' debts all be written off?

EPA

A step out of debt?

WITH backers that include Bono and the pope, the campaign for poor-country debt relief has proved a powerful coalition. A decade ago, international institutions, such as the International Monetary Fund and the World Bank, denied that debts owed to them needed to be forgiven at all. Since 1996, however, a programme, inelegantly called the HIPC initiative, has tried to cut the debts of 38 heavily-indebted poor countries to "sustainable" levels. Now, ahead of the autumn meetings of the IMF and the Bank this weekend, America and Britain are touting rival plans to rub out the debts entirely.

America wants simply to write off the debts of HIPC countries. George Bush's Treasury officials point out that part of the money these countries borrow from international institutions goes straight back to Washington to service existing loans. Why not simply cancel the debt and switch to grants? Although the Treasury is not promising any new money, it says that eliminating debt would be a big step forward.

Britain, by contrast, is offering more cash and wants more countries to get help. On September 26th, Gordon Brown, the chancellor of the exchequer, said that the goal should be debt relief of up to 100% for all poor countries, not just those that are officially deemed to be heavily in debt. To "lead by example", he promised that Britain would pay its share (10%) of the debt service owed by poor countries to the World Bank and the African Development Bank. He also called for the IMF's gold to be revalued to help pay the Fund's share of the debt write-off.

Debt activists are delighted. They hope that rivalry between rich countries will bring both debt write-offs and pledges of new money. Staff at international institutions are more sceptical, particularly about the American proposal, which they argue will drastically cut their resources. Debt forgiveness, they say, means that less money will flow back to the institutions to be lent to other poor countries later.

A better question, though, is whether total debt relief makes any sense. There is no doubt that the HIPCs include the world's most desperate countries. Virtually all are in Africa; many are ravaged by AIDS. In all, 27 countries have had some relief, and 14 have seen some debt eliminated. More than half of the total HIPC debt stock has been written off, saving the borrowers $900m a year in debt-service payments. Yet many HIPCs still have unsustainable debts. The current HIPC initiative will not solve their problems.

The political appeal of the American plan to wipe out debt and then move wholly to grants is plain. However, there is little evidence of the generosity necessary to make it work: the Bush administration has so far been unable fully to fund its own ambitious bilateral-aid plan, the Millennium Challenge Account.

That said, fears about the plan's effects on the financial health of the multilateral institutions are overblown. Bank staff point out that eliminating HIPC debt would reduce their soft-loan fund's capital base by 25% in present-value terms, and hence their future capacity to lend to the poorest countries. The hit would come after a decade, because the Bank's soft loans have a ten-year grace period. But this assumes that today's HIPC countries really will be in good enough shape to begin net repayments by then. It is more likely that they will not be able to resume repayments—in which case debt cancellation will make the Bank's finances no worse.

The problems with America's ideas lie elsewhere. Eliminating all the HIPCs' debts is both unfair and risky. The HIPCs do not include all the poorest countries, just the ones that are both poor and heavily indebted. Why should Uganda have all its debts cancelled but not Bangladesh, a poor country that has managed its debts more competently?

By broadening the prospect of relief to all poor countries, the British proposal eliminates that inequity. But it does not eliminate the risks associated with complete forgiveness, particularly that debt elimination might not foster prudent policies in the future.

One reason to worry is that newly debt-free countries could be tempted to rash new borrowing. Some private-sector lenders might be foolish enough to lend to a country with such a dismal credit history, but no current debt burden. Another possible cause for concern is the loss of “conditionality”. Once multilateral debt has been wiped out, the Bank and the IMF lose much of their leverage over poor countries' policies. That said, the evidence that “conditionality” leads to good policies is mixed at best, particularly when the World Bank and others are in effect renewing unrepayable loans perpetually.

The truth is that poor countries need more resources from the rich. If competition to sound most generous leads rich countries to put more money in the aid pot, then it is worth pursuing. But HIPC debt relief alone is no panacea.

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About sponsorship

Global warming and insurance

Awful weather we're having

Sep 30th 2004
From The Economist print edition

EPA

Why climate change could mean higher insurance premiums

FOR insurers as for Floridians, the recent pounding from four back-to-back hurricanes, costing $20 billion or so, has been highly unusual, as well as unwelcome. Not since Texas in 1886 have so many hurricanes struck one American state in a single season. And Mother Nature seems to be fairly bursting with surprises. In Europe, last summer was the hottest on record and severe windstorms have been on the rise. On a ten-year view, the frequency of weather disasters has tripled since the 1960s and insured losses have risen ten-fold, according to Munich Re, the world's largest reinsurer.

Some might ascribe all this to global warming. In fact, this is far from being established—and hurricanes are especially hard to assess. Whatever the cause, the world's insurers are counting the cost of more volatile weather. “Higher variability means more uncertainty means normally a higher price,” says David Bresch of Swiss Re, Munich Re's biggest rival. However, predicting climate change and its effects in the future is harder than simply reacting to volatility today. The possibility that temperatures might rise and, for example, cause more flooding in Europe has not yet led most insurers to increase premiums and deductibles.

Since reinsurance contracts are renewed every year, adjustments can be made speedily if necessary. And insurers are constantly updating their disaster models. Swiss Re has already plotted out half a million possible storms in North America and the Caribbean alone. On the upside, climate change could make some areas less stormy. Munich Re has been studying warming patterns for more than 20 years; it expects warmer weather in Europe (more storms and flooding in winters, more heatwaves, severe storms and wildfires in summer) and some of the same in North America. Gerhard Berz, a meteorologist who heads the company's geo-risk research group, says that more study of the oceans' role in climate change would be especially helpful to scientists and insurers.

If insurers and reinsurers ever feel confident enough of climate change to act, premiums and deductibles are likely to rise. Reinsurance prices are normally calculated on the basis of losses in the past five to ten years, according to Mr Berz at Munich Re, so if warming trends accelerate, price increases could follow with a slight lag. Reinsurers would also be likely to insist on stricter limits on their coverage.

Climate change could also increase demand for catastrophe (“cat”) bonds. These are a form of securitised risk, offered by insurers or reinsurers to limit their exposures. The investor receives a high rate of return (often above 10%) in exchange for the risk of losing his principal if losses from a hurricane, windstorm or terrorist attack exceed a certain level. (So severe must the disaster be that even the recent storms have not been strong enough to trigger payouts, though prices on the bonds have wobbled.) Such instruments

are getting more popular, with hedge funds among the most eager investors: cat-bond issues totalled $1.7 billion in 2003, up 42% from 2002, according to Guy Carpenter, a reinsurance brokerage firm. Cat bonds for other big risks such as flooding could be introduced if climate change creates the need, according to Mark Hvidsten of Willis, an insurance broker.

Some of the worst risks, though, are likely to be borne by governments. American states such as Florida (for hurricanes) and California (for earthquakes) are already involved in coverage for high-risk areas. Governments are even more instrumental in prevention: insurers rely on them to curb carbon emissions, fund climate-change research and build protections such as flood defences. Perhaps governments and insurers together could gently suggest to citizens that building new houses in flood- or hurricane-watch areas is not always the best idea.

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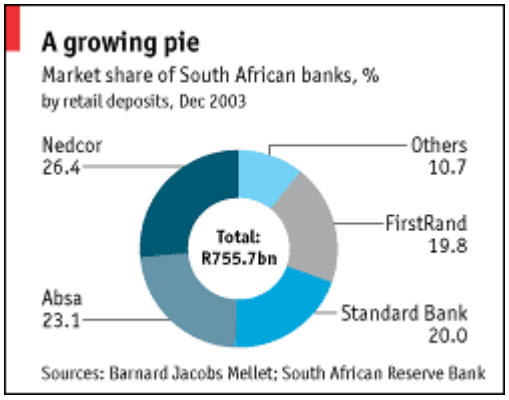
About sponsorship

Banking in South Africa

The eagle circles

Sep 30th 2004 | DOBSONVILLE, SOWETO
From The Economist print edition

Barclays plans its return



THE Dobsonville branch of Absa is bustling. Customers line up before three cash-dispensing machines; another long queue snakes to a counter of eight human tellers. A family waits to open an account for the grandmother, her first ever. She has a 60,000-rand ($9,300) payment from the government to deposit, compensation for an old land claim.

Dobsonville is a newly middle-class part of Soweto, a sprawling suburb of at least 3m people south-west of Johannesburg. The area is packed with new houses, honking minibus taxis and tiny businesses, but few banks. Once, Absa was a staunchly white, Afrikaner bank. It waited until 1996 to open its Dobsonville branch, and another five years before opening another in Soweto. Two more are now planned, as Absa tries to reach new customers in the emerging black middle class.

Soon Barclays could be here instead. The British bank was forced out of apartheid South Africa in 1986 by angry consumers (especially students) in Britain, who accused it of supporting the white-minority government of the time. It has since returned to the country, where it has its African headquarters and a corporate-banking business. Last week, it confirmed that it wants a controlling stake in Absa, one of the country's top retail banks. The bid is likely to cost over 20 billion rand, in cash. There are rumoured to be possible rival bidders, such as Standard Chartered, another British institution, which bought a South African online bank last year. So far, though, Standard Chartered has made no move to snatch Absa as well.

In fact, all South Africa's big banks—Absa, Nedcor, FirstRand and Standard Bank—look alluring. All are locally owned and make healthy profits. Absa earned 4.4 billion rand in the year to March, 29% more than in 2002-03. The economy is buoyant, enjoying low interest rates, a booming housing market and a strong currency.

The market is ripe for growth. Some 13m, mostly black, South Africans lack accounts, but might be tempted if banks only tried. In places like Dobsonville, taxi drivers earn easily enough to have accounts, but only when a black woman, Innocentia Nkomo, became Absa's branch manager in 2002 did anyone think to approach drivers working nearby. Around 50 are now among the branch's best customers, with “platinum” savings accounts.

Mrs Nkomo now eyes those who run other small businesses, such as fruit stalls and hairdressing salons. Many still keep their profits stuffed under the mattress or borrow from loan sharks. A new owner of Absa could ensure more of these people are attracted by making small changes. Cutting charges would be a start: at Absa it costs 25 rand every time a customer withdraws cash over the counter.

South Africa's finance minister, Trevor Manuel, will have the final say over whether Barclays may have its prize. Bigger unions grumble that a foreign owner would take profits overseas, and want Mr Manuel to stick to a policy that banks be locally owned. He will probably be swayed more by the thought of a large inflow of foreign direct investment. Anyway, his boss, President Thabo Mbeki, has apparently already given the bid his blessing.

One other possible obstacle seems unlikely to stop a deal. Under the terms of an agreement between the country's financial companies and the government, more of the equity in these firms must be passed into

black hands, as part of “black economic empowerment”. Thus Barclays needs, if only for political reasons, support from Batho Bonke, a black-owned group that holds 10% of Absa's shares. This week one of Batho Bonke's owners, Tokyo Sexwale, gave glowing support to Barclays, calling the British bank's putative bid “a strong vote of confidence in the financial and monetary system”. The people of Dobsonville would hope so too.

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German banks

Step by step

Sep 30th 2004 | FRANKFURT
From The Economist print edition

Slow moves towards consolidation of the sector

IT'S like a multidimensional chess game played at glacial speed. Occasionally a piece is moved. There is no obvious strategy. Yet the outcome seems clear: eventually, two or more of Germany's biggest private-sector banks will merge, and so will clusters of publicly owned *Landesbanken*, or state banks.

This week Commerzbank, Germany's third-biggest listed bank, made a move, with the departure of Mehmet Dalman, head of investment banking. It was no surprise. Commerzbank's expensive foray into investment banking has not been a success—the securities division made an operating loss of €47m ($57m) in the second quarter. Mr Dalman now wants to start a hedge fund.

A decision on what to do with the investment-banking unit awaits a study by Mercer Oliver Wyman, a consulting firm, due in October. But even non-consultants can see the writing on the wall for many of Commerzbank's 1,200 investment bankers in New York, London, Tokyo and Frankfurt. The division is likely to concentrate on serving the bank's core clients: small and medium-sized companies, mostly in Germany.

Although Commerzbank has cut costs fiercely in the past two years, its irrational adherence to Mr Dalman's outsized division has made it unattractive to potential buyers, especially those with investment bankers of their own. It may now be a better target—for example, for Deutsche Bank, Germany's biggest bank. Deutsche has been under pressure from politicians, media and the top brass of corporate Germany to buy a domestic rival. Commerzbank is beginning to look a better bet than the other options, Postbank and HVB.

On another part of the board, the public-sector banks are slowly sorting themselves out. On September 29th Landesbank Baden-Württemberg, the strongest *Landesbank*, said that it would buy Landesbank Rheinland-Pfalz (LRP), its neighbour in south-western Germany, at the end of the year.

As part of the deal, WestLB, another big public-sector bank, will sell its 37.5% stake in LRP. It is building a cluster of its own in the north-west. In the centre of the country, Landesbank Hessen-Thüringen is forging stronger links with a group of local savings banks. It is trying to buy the Frankfurter Sparkasse, which, unusually for a savings bank, is not publicly owned. In Bavaria, to the south, there may eventually be a cross-sector solution, if Bayerische Landesbank merges with listed HVB.

The game will take years rather than months to complete, thanks to provincial politics and giant egos. But Deutsche may have a one-piece advantage: Mr Dalman's successor is expected to be Wolfgang Matis, of Deutsche Bank.

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Economics focus

Growing apart

Sep 30th 2004
From The Economist print edition

The euro seems to have made European economies less, rather than more, synchronised

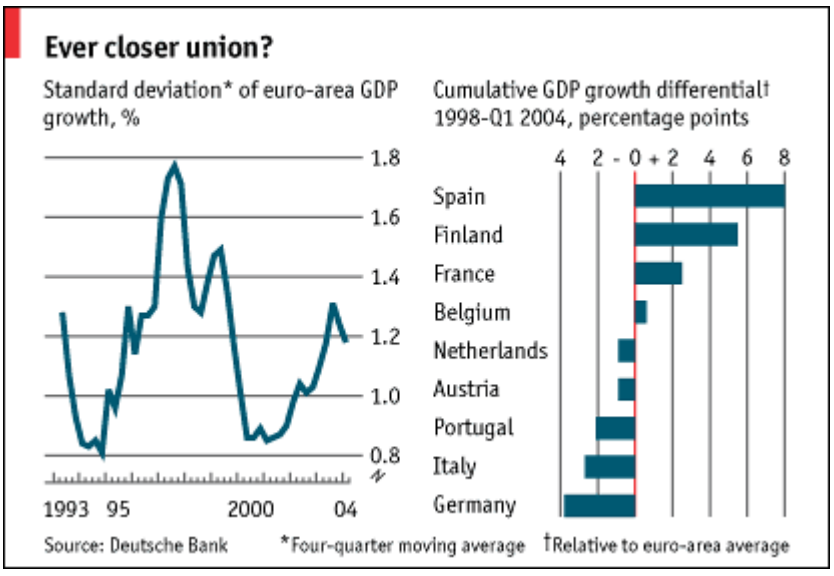
Get article background

AS IT approaches its sixth birthday, a steady flow of reports has appeared, grading Europe's single currency on its performance. The Organisation for Economic Co-operation and Development, the International Monetary Fund and the European Commission have all weighed in. The commission, predictably, sees the euro as a success, albeit a qualified one. Inflation, it notes, has been low and stable. Growth has not been brilliant, but the currency has at least defied the gloomiest forecasts of economic instability—a minimal requirement, you might suppose. The switch to new notes and coins at the start of 2002 went more smoothly than expected.

The main economic purpose of the single currency is to deepen integration among its members, by reducing the costs of cross-border commerce. Along with freer movement of labour and capital, the common coin might in turn make business cycles in different euro-zone countries more aligned. Indeed, this was one argument in support of the single currency in the 1990s; opponents worried about whether cycles were sufficiently in tune for the thing to work. It is early days, but the commission thinks that such cyclical convergence is slowly happening.

On this point, economists from two German banks have doubts. First, a team from Deutsche Bank argues that Europe's economies are now marching, as much as ever, to the beats of their own individual drums. Take the second quarter of this year: real GDP grew by a healthy 3%-plus, at an annualised rate, in France, but shrank by 0.8% in the Netherlands.

How does that compare with the days before the euro? The authors computed the standard deviation—a measure of how far each country's figures stray from the average—of quarterly economic growth rates over the past decade for the nine countries that publish quarterly figures (see the left-hand side of the chart below). A rising standard deviation implies that economies are diverging; a shrinking figure, that they are coming together. Although there is evidence of convergence between 1999 and 2001, since then individual countries have gone their separate ways.



Over time, the effects build up (see right-hand chart). The most striking difference is between Spain, whose economy has grown by 18.7% since 1999, around eight percentage points more than that of the euro area as a whole, and Germany, whose GDP has expanded by only 7%. To some extent, it might have been expected that Spanish standards of living would rise towards German levels. But France has also outstripped Germany, even though its GDP per head is similar. Euro-area countries seem to be out of sync with each other.

The divergence in the growth rates of euro members conceals much larger, and widening, differences in the components of economic growth: changes in consumption, investment, government spending and net exports. Take consumption, the biggest element. Between 1998 and the first quarter of this year, consumer demand was buoyant in Spain, France and Finland, but flaccid in Germany, Italy and the Netherlands. The standard deviation of consumption growth has doubled since 2001 and is now higher than it was in 1999. In investment, the differences are even more striking. Capital spending in Germany fell by 6.3% during the period, while in Spain it rose by 26.3%. The investment gap widened markedly in 2003. In trade, there is a similar story: Italy's export growth has been weak, while German and Austrian exporters have done far better than the average for the euro area.

David Owen, of Dresdner Kleinwort Wasserstein, takes a slightly different view. He argues that the divergence of real GDP in the euro area's four biggest economies—Germany, France, Italy and Spain—has been tamed since the euro's birth. Indeed, these economies became increasingly in sync during the economic upturn in 2000, a phase when growth rates are even more likely to go their separate ways. But he also points to the divergence of consumption, investment and (especially) exports in recent years. He ascribes this in part to differences in real exchange rates: although nominal exchange rates are fixed, differences in inflation across countries can still affect real exchange rates. Germany's low inflation, for example, has made the country's exports relatively cheap.

Furthermore, inflation rates, as measured by GDP deflators, have diverged. As a result, nominal growth rates—the sum of real GDP growth and inflation—have also diverged. Mr Owen surmises that this may have knock-on effects on European stockmarkets. Because stockmarkets tend to focus on nominal variables, such as profits, they may come to depend more, not less, on nationality.

Europe does the splits

Why the continued divergence? Perhaps it is simply too early to expect much to have changed. But the Deutsche Bank economists speculate that, despite efforts to converge in advance via product markets, services and financial markets, countries entered the single currency from very different starting points. Once in the euro, these differences paved the way for increasing divergence in real growth. Europe's single interest rate has helped to widen the gap: monetary policy has been too tight for sluggish Germany, for example, holding down its growth and inflation rates, and too slack for faster-growing countries. They finger the usual suspects. Labour-market rigidities aggravate real divergence, by failing to allow wages to adjust to local circumstances. Inflexible fiscal policies, in part the result of efforts to comply with the stability and growth pact, have needlessly deepened recessions.

Even so, it is hard to say how much divergence is too much. Different parts of America, itself a single-currency area, grow at different rates, and no one doubts the future of the dollar. America, though, has the labour-market flexibility and fiscal mechanisms that help to make a single-currency zone work fairly smoothly. These, however, Europe lacks.

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Correction: credit derivatives

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From The Economist print edition

In our story on credit derivatives in last week's issue ("Russian doll"), we said that the outstanding nominal amount of collateralised debt obligations at the end of 2003 was $800m. We meant $800 billion. Sorry.

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Social networks

Circles of friends

Sep 30th 2004
From The Economist print edition

Corbis

What maths tells us about us

ALBERT EINSTEIN once remarked that common sense is the collection of prejudices someone has acquired by the age of 18. As such, it can be positively misleading as a guide to physicists studying fundamental particles or the structure of the universe. Instead, such researchers rely on mathematics. When it comes to studying human interactions, though, the reverse might be expected to be true—that common sense has everything to do with it, and mathematics nothing. But that turns out not to be the case. For one branch of the study of social networks seeks to model how people interact by using a type of maths known as graph theory.

The graphs of graph theory consist of sets of points ("nodes") and the lines between those points ("links"). A link, in turn, can be directed (one node points to another) or undirected (two linked nodes have equal status). It sounds simple, and it is. Nevertheless, building on that framework, and understanding, among other things, whether some nodes tend to have many more links than others, and whether "cycles" of linked nodes are common in a graph, can allow graph theorists to say powerful things about, say, a telephone network or the internet. The question facing those studying social networks is: can the tools of graph theory also be used to reveal things about human behaviour that common sense does not?

Some mathematicians believe they certainly can. Jonathan Farley, a researcher at the Massachusetts Institute of Technology, is one of them. He helped to organise a workshop held on September 28th and 29th at Rutgers University, in New Jersey, which focused on the applications of graph theory to homeland defence and computer security. Dr Farley gave a talk at the workshop about using the theory to model networks of terrorists. In particular, he is interested in trying to work out whether or not the chain of command in a terrorist network has been disrupted by a particular action.

Nefarious networking

To do this, he models terrorist networks using a type of graph called an ordered set. This can be used to represent hierarchies. Dr Farley believes that if fed data on the number of members of a network who have been apprehended, an ordered-set model can give the authorities an estimate of the probability that the network has been disrupted. As Dr Farley is the first to admit, his model is rudimentary. Nonetheless, he believes it gives a better estimate than naive intuition would—and he has enough

confidence in this belief to have founded a company that will sell analyses based on such techniques.

Although studying terrorist networks sounds a sure way to win grant money, it might eventually run into the sand simply because of the difficulty of gathering relevant data about real terrorist networks. Indeed that, to a lesser extent, can be a problem for any study of a human network. People change their behaviour under scrutiny, and lie on questionnaires. One group of researchers has thus decided to cross the species barrier and test its models on another highly social mammal, the dolphin. No questionnaires are involved, and dolphins seem to worry about human observers about as much as humans would worry about an observant pet.

David Lusseau, of the University of Aberdeen, in Scotland, and Mark Newman, of the University of Michigan, in Ann Arbor, chose to look at the dolphins of Doubtful Sound, off the coast of New Zealand. Their results are about to be published in *Biology Letters*. Dr Newman's analysis of the animals' interactions suggested that what looked, superficially, like a single group was actually more akin to two groups held together by two “mutual friends”. That prediction was borne out when Dr Lusseau saw the friends concerned leave the area. The Doubtful Sound dolphin community duly split in two. And when, after a period, the two mutual friends returned, the daughter groups rejoined precisely as the model predicted.

Dolphins, of course, are not people. And the Lusseau-Newman friendship model has still to be tested on humanity. Peter Bearman of Columbia University, however, is doing something similar, though looking not at friendships, but at sexual relationships. These have the virtue of being more clear-cut than friendships (did you sleep together or didn't you?) and thus what is or is not a link between nodes is unambiguous.

Earlier this summer Dr Bearman reported, in the *American Journal of Sociology*, an examination of high-school students' sexual activity and romantic relationships. When he plotted these as a graph, he found that it usually took many links (the record was 37, in a 500-pupil school) to get from one individual to another via an intervening chain of romantic entanglements—if, indeed, it were possible to make a connection at all.

That is in marked contrast to the sex lives of adults, where the sexual chains between people in a community tend to be rather short. It is also surprising, given the apparently cliquey nature of teenage life. Indeed, there were some specific surprises. One was that if two teenage couples broke up and one member of each couple started dating a member of the other couple, the two “dumpees” would almost certainly not form a relationship of their own. Put in terms of graph theory, there were no cycles of four—rings of four nodes with links connecting them.

Such results are of more than merely prurient interest. This sort of graph theory can yield insights into how sexually transmitted diseases spread—and how that spread might be stopped. The hopeful news Dr Bearman's work brings is that it should be easier to stop the spread of sexually transmitted diseases through a teenage-type graph than an adult one, since the spindly chains of connection between individuals can more easily be broken. Clearly the prejudices acquired by age 18 are not quite sufficient to explain the impact of lovers acquired afterwards.

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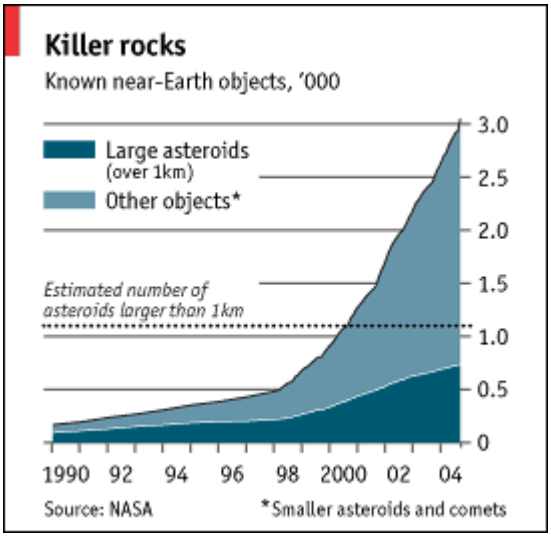
Near-earth objects

Far away, so close

Sep 30th 2004
From The Economist print edition

A large asteroid sweeps by Earth. Where are the others?



ON SEPTEMBER 29th, Toutatis, an irregularly shaped rock a few kilometres in diameter, came within 1½m kilometres (1m miles) of Earth—about four times the distance of the moon. If an asteroid the size of Toutatis were to hit Earth, it would be by far the biggest natural disaster in human history, quite possibly causing the end of civilisation. The dust thrown up would obscure the sun for months, leading to large-scale crop failure. If it landed in the ocean (more likely than not, given that the sea covers two-thirds of the Earth's surface) an enormous wave would be generated, demolishing whatever lay in its path. And in the longer term, there would probably be profound disruption of the climate.

Doom—and gloom—for certain. But Toutatis missed the Earth by a comfortable margin. What is more, astronomers were well aware that it was coming. The asteroid was discovered in 1989, and has been comparatively well-studied since then, because its orbit has brought it close to Earth three times in the intervening years. However, at the time of Toutatis's discovery, finding asteroids whose orbits brought them especially close to Earth was a matter of chance—there was no worldwide programme to search for them. This began to change in the early 1990s, but did not really take off until Spaceguard, an effort co-ordinated by NASA, America's space agency, began in 1998. Since then (see chart) the number of known near-Earth objects, or NEOs, (a term that includes not only asteroids but also those comets whose orbits regularly sweep them close to Earth) has increased dramatically.

Spaceguard's stated goal was to discover 90% of the near-Earth asteroids larger than 1km in width by 2008. Of course, if the exact total is unknown, it is impossible to know what 90% of that total is, but astronomers have statistical models that should allow them to estimate the number reasonably accurately. The value of 1km was chosen as the cut-off because it is asteroids of this size or larger that are likely to cause a global, rather than merely a local, calamity.

Like many of NASA's science missions, Spaceguard has performed, if anything, ahead of expectations—over 70% of the large asteroids have been found already, at a meagre cost of $4m a year. Indeed, a single telescope in New Mexico, called LINEAR, has found more NEOs than all other telescopes on Earth combined. But even if Spaceguard does succeed, another problem remains—smaller asteroids, of the size believed to have caused a huge explosion above Tunguska, in Russia, in 1908. While 1km-size and bigger asteroids are thought to hit only once every 500,000 years, on average, rocks 50-100 metres across, like

the Tunguska object, are thought to hit the planet once every thousand years. That is why a NASA committee headed by Grant Stokes, LINEAR's chief scientist, recommended in August 2003 that a mission should start in 2008, when Spaceguard ends, to catalogue 90% of the potentially hazardous NEOs which are bigger than 140 metres. That size was chosen as the smallest for which the cost of deploying a system (estimated by Dr Stokes at $300m) would be offset by the potential life- and property-saving benefits.

However, the odd thing is that, despite the success of efforts so far, and the likely success of future efforts, there is no official plan in place for dealing with any hazardous asteroid that is found to be on a collision course with Earth. The popular science-fiction method of dealing with the problem—detonating a nuclear weapon next to the object to divert its course—is seen as too uncertain. The alternative—strapping rocket engines to the rock and using their thrust to alter its orbit—would not work either, unless the project began several decades before the impact was due. That is why a group of scientists and former astronauts formed the B612 Foundation (named after the home asteroid of Antoine de Saint Exupéry's little prince) in 2002. Their goal is to develop a way of altering the course of an asteroid using an ion rocket, which pushes electrically charged atoms out of the back. This is more efficient than the hot gas which provides the thrust in a conventional rocket.

The B612 group believes such a system could be ready for use by 2015, and suggests it should be tested shortly thereafter on a non-threatening asteroid. A noble goal—it is, as the little prince might have said, a matter of consequence.

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Taxonomy

All bar none?

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There may be more species on Earth than previously imagined

IT IS bad enough that the Earth may be experiencing the largest mass extinction since the dinosaurs died out. Almost as bad—at least for science—is that as many as 90% of those species are dying without ever having been recorded. However, a new, rapid method for classifying species may ameliorate the latter problem, and help researchers to get at the question of just how much is being lost.

DNA barcoding, a technique proposed last year by Paul Hebert of the University of Guelph, in Ontario, Canada, has just had its first big trials, and has passed them with flying colours. It works by examining a particular part of a particular gene that is found in all animal species. The gene in question is called cytochrome c oxidase I (COI). It is easy to study because every cell contains lots of copies of it in simple, easily isolated structures called mitochondria. By contrast, most genes are hidden away in a cell's nucleus, where they are much harder to get at. Mitochondrial genes also tend to mutate rapidly, so meaningful differences between species build up quickly. And by concentrating on a mere part of COI—a section which is 648 genetic "letters" long—Dr Hebert has simplified the process still further. It is this sequence that he refers to as the "barcode". All members of a species would be expected to have similar barcodes, but those codes should differ from species to species.

The first trial, just published in *PLoS Biology*, an online journal, sought to establish that the results of genetic barcoding agree with those of traditional taxonomy—the labour-intensive process of classifying species by their physical characteristics. (The formal biological definition of a species is a group of individuals that breed together, to the exclusion of others, in the wild. But the practical definition is usually based on reliable differences in anatomy between such groups.) In the study, DNA samples from birds classified by traditional taxonomy into 260 species were subjected to the technique. In almost all cases, the two classifications agreed. But Dr Hebert's technique went further. It suggested that four of the traditional species are each made up of two closely related species, and should be split.

That observation presaged the second study, which explicitly addresses the question of such "cryptic species". This study, just published in the *Proceedings of the National Academy of Sciences*, examined a butterfly called *Astraptes fulgerator*. At least, that is what the traditionalists call it—and have done so since 1775, when it was first classified. But there have, for a long time, been doubts about whether *Astraptes fulgerator* really is a single species. That is because although the adults look similar, the caterpillars vary quite a lot, and also seem to prefer different food plants.

Barcoding showed that these suspicions are well-founded. Ten sorts of barcode turned up, suggesting that *Astraptes fulgerator* actually consists of at least ten species—and that is only the number from the part of north-western Costa Rica where the specimens tested came from. Since *Astraptes fulgerator* ranges from northern Argentina to the southern United States, there is probably quite a bit more variety to be found in this one "species" alone.

Put into widespread use, therefore, DNA barcoding could begin to settle basic questions such as how much diversity there actually is in the living world. At the moment, estimates for the number of multicellular species in existence range from 10m to 100m—hence the uncertainty about how fast they are becoming extinct. Barcoding might also let scientists identify hot spots of genetic diversity, and work to protect those areas first.

There are still some sceptics around. In a commentary published in the same issue of *PLoS Biology*, Craig Moritz and Carla Cicero, of the University of California, Berkeley, say the method will probably run into practical problems. Species which diverged recently might not show enough difference in their barcodes to be recognised as separate. And some species might not be detectable using only the COI gene. But Dr

Hebert thinks these problems can be resolved. The pilot studies suggest that 96% of animal species can be identified precisely with his method. Even problem species could be classified approximately, and then handed over to traditional taxonomists for a final once-over.

Already the Canadian government has provided C$5m ($3.9m) to begin cataloguing the 10,000 most economically important fish, birds, mammals and agricultural pests. Meanwhile, in April, the Consortium for the Barcode of Life, a collaboration of natural history museums and herbaria, launched an international effort to build a comprehensive library of species' barcodes. The supermarket of life, it seems, is now open for business.

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Evolutionary theory

A dog's life

Sep 30th 2004
From The Economist print edition

Too much evolution can lead to extinction

NATURAL selection is blind to the future. So it is possible, in theory, for a species to evolve itself merrily to extinction by adopting a strategy that works in the short term, but not in the long. That has never been observed in practice. But a study published in this week's *Science*, by Blaire Van Valkenburgh, of the University of California, Los Angeles, and her colleagues, suggests it is true. Dr Van Valkenburgh has studied the fossil history of one group of mammals, and found a repeated pattern of evolution that seems to lead to extinction.

The mammals concerned are the dog family, a group of carnivores known to zoologists as the Canidae. This family is divided into three. Living dogs, wolves, jackals and foxes, together with their ancestors, are dubbed the Caninae. And there are also two extinct groups, the Hesperocyoninae and the Borophaginae. The past 50m years have seen a repeated pattern of particular carnivore lines proliferating, diversifying and then declining to extinction for no very apparent reason. Dr Van Valkenburgh's hypothesis was that there was indeed a reason, common to all of these cases, and that it was that connected with an old idea called Cope's rule.

The rule in question is that small animals evolve into large ones, but not vice versa. This makes sense. Size brings security from predation, success in competition for mates (at least if you are male) and a lower surface area to volume ratio (which reduces heat loss). The downside is that big animals have to eat more than small ones.

Dr Van Valkenburgh took this line of reasoning a stage further. If you are a carnivore, the easiest way to eat more is to specialise in large prey. And that, in turn, gives you a further reason to grow big. But the problem with this is that large prey are rarer than small ones, so specialising in them leaves you vulnerable to relatively small ecological changes. If your preferred food supply vanishes you may not, as a smaller species would, have any suitable alternatives. Extinction thus beckons.

To test this idea, the researchers turned to the fossil record—in particular to the animals' teeth, which often survive when bone disintegrates. They were able to work out the likely average sizes of a range of fossil species from the well-established relationship between tooth size and body size in living canids. Then, by examining the anatomy of the teeth themselves, and of fossil jaws, when available, they were able to get a good idea of the type of prey the animals were eating.

The same trend was apparent in both the Hesperocyoninae and the Borophaginae. The number of large species with adaptations suggesting specialisation on large prey increased with time. Small omnivores became rarer (their place being taken by members of the newly evolved Caninae). And, crucially, the large beasts did not hang around as long as the small. The average lifetime of such “hypercarnivorous” species was 6m years. Smaller, less specialised species averaged 11m years. It thus appears that evolution really can lead to extinction.

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About sponsorship

The fishing industry

Heading for the final fillet

Sep 30th 2004
From The Economist print edition

Corbis

A bleak outlook for fish stocks

Get article background

FISH becoming ever more scarce; greed, crime, cruelty, waste, folly, destruction, hypocrisy, ignorance, pusillanimity, deception and the possibility of extinction all becoming ever more abundant. That is the theme of Charles Clover's book about the world fishing industry.

The problem with fishing is as follows. Fish are a wonderful source of protein, not just for the swelling populations of poor countries but, because they are generally better for you than meat, also for health-conscious guzzlers in richer places. As man's appetite for fish has grown, so has his ability to catch them. Modern gadgets—sonars, global positioning system plotters, sea-mapping software, echo sounders, radio beacons, bathymetric generators, "fish aggregation devices" and the like—enable today's vast fishing boats to find and kill their prey as never before.

Although the signs of growing scarcity are everywhere—smaller fish, smaller catches, sometimes no catch at all—most of the efforts to manage fish stocks or control overfishing have failed. When rich or big countries, whether Japan, China or various members of the European Union, exhaust their traditional fisheries, they move on to new ones. With the EU's blessing, European countries—Spain is the most rapacious—buy fishing rights from African states for trifling sums and then set about their predations. They, and others, have also moved on to deplete the stocks in the world's last waters to be exploited—round Antarctica, in the Indian Ocean and in the South Atlantic, just as they have fished out the stocks in the North Sea, the Mediterranean and the Grand Banks off Canada.

As they exhaust the big fish, they may have to go after smaller and uglier specimens that they used to throw back. They may also have to change the off-putting names of the creatures of the deep to make them more palatable: the Patagonian toothfish shows up on fancy menus as Chilean sea bass. But demand grows and grows, and with it the plunder of the seas.

Though some kinds of fish, such as prawns and salmon, can now be farmed, industrial fishing is still

The End of the Line: How Over-Fishing is Changing the World and What We Eat
By Charles Clover

Ebury Press; 320 pages; £14.99

Buy it at Amazon.co.uk

largely a matter of hunting, or, to use Mr Clover's term, mining. “Mining” is apt because commercial fishermen are now hauling fish out much faster than they can be replenished. Everywhere the outlook is bleak. In many places, certain species may never recover.

Umpteen international agencies busy themselves with monitoring, suggesting and complaining, but to little avail. Politicians in rich countries yield spinelessly to the short-term interests of fishermen, who can still tweak the sympathies of other voters in a way that even farmers cannot. And consumers are resolutely uninterested. They may mind about dolphins, or the albatrosses which get snared by the 125km (80-mile) lines sometimes used to catch tuna. Yet the victims of “friendly” practices include many more creatures: whales, turtles, sharks, rainbow runners, dolphin fish, triggerfish, wahoo, billfish, mobula, manta rays, mackerel, barracuda and so on. This “by-catch” is generally flung back into the sea.

The waste is appalling: as much as 85% of the take of Spanish prawn fishermen may be by-catch. The cruelty is equally vile: sea lions and porpoises drowned in nets, dolphins thrown back into the sea with beaks broken and hunks of flesh hacked from their sides, tuna gaffed bloodily, huge manta rays left to gasp their last on deck. The damage is not done only to animals (yes, fish are animals, though self-styled animal-lovers seem far more concerned about foxes, at least in Britain). Trawlers and dredgers wreak destruction across the seabed, crushing entire ecosystems of corals, algae and crustaceans as they go. And, thanks to subsidies and absurdities such as the EU's common fisheries policy, the taxpayer helps to finance this rape.

All this is laid out—like fish on a slab—in Mr Clover's excellent book. Little escapes him as he travels from Tokyo's fish market to Vigo in Spain, from marine reserves in New Zealand to the coast of Mauritania, from Newfoundland to Brussels. He exposes the follies of fishermen, politicians and celebrity chefs, and he ponders the central problem—the age-old “tragedy of the commons”, whereby anyone with access to a common resource has an interest in over-exploiting it.

What can be done? In time, farming may help, though most farmed fish must be fed with other fish that have been taken from the sea: sometimes 20 tonnes of dead fish, ground up, is needed for one tonne of live. Tuna farming has proved hugely popular, though it is really fattening: the fish are caught in nets and reared in cages. Moreover, says Mr Clover, it has led to wildly unsustainable catches and, in the eastern Atlantic and the Mediterranean, the collapse of the system for gathering catch information and imposing limits.

To make matters worse, most of the problems of pollution and cruelty associated with farming have yet to be overcome. Salmon—which in the wild swim freely across oceans—are condemned to live lice-ridden and crammed into cages. In Ireland this has brought disease and destruction to local stocks of wild sea trout. Escaped farm fish risk playing genetic havoc with local salmon.

Yet some fishery policies have been shown to work, especially in Iceland. Mr Clover suggests independent management, long-term transferable quotas, marine reserves and, above all, far greater openness, ideally with the help of satellites and the internet, to reveal what every boat is doing. Thus could the public help to police all those who go down to the sea in ships and occupy their business in great waters. His counsel seems eminently wise—and most unlikely to be taken.

The End of the Line: How Over-Fishing is Changing the World and What We Eat.
By Charles Clover.
Ebury Press; 320 pages; £14.99

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About sponsorship

A round-up of thrillers

Know your limits

Sep 30th 2004
From The Economist print edition

DURING the cold war, three writers set the standards by which all subsequent thrillers, and their protagonists, would be judged. Frederick Forsyth, John le Carré and Robert Ludlum invented lone assassins, maverick investigative journalists and misunderstood spies that epitomised the moral quandaries and geopolitical fears of their day.

Mr Forsyth's first three books stand above the rest; he, in particular, understood that a convincing protagonist needs a dramatic quest that is neither too personal nor too apocalyptic. Killing General de Gaulle, for instance, was fine. But the moment that he introduced plots where nothing less than the demise of the planet was at stake, Mr Forsyth, like so many others, lost his allure. Yet then, after the end of the cold war, along came the internet and global terrorism. Suddenly, throwing the future of mankind into question became acceptable again in fiction. So how does the thriller protagonist fare these days?

Terence Strong has been writing about fictional warriors from Britain's Special Air Service (SAS) for over 20 years. In his latest book, “Cold Monday”, Ed Coltrane is out of the regiment, drinking too much and running into the sands in his search for the Serb killers who slaughtered his Bosnian wife, a UN translator. He strikes a bargain with the British security services: he'll be told where the guilty Serbs are, and national interests will be served by their demise at Coltrane's hands. Things go badly wrong, and our ex-Hereford hero finds himself on the run from a sinister Brussels security agency that is doing the dirty work for a very menacing European Commission.

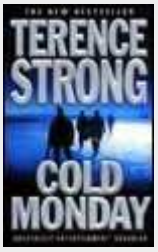
This book works well because Mr Strong sticks with what he knows: the ex-SAS man is spot on, his woman bodyguard a perfect portrayal of a former military undercover agent; meanwhile, the cities and woods of England act as a likely setting. The good characters are sympathetic, while the bad are truly vile.

In “The Warlord's Son”, Dan Fesperman, an American foreign correspondent who covered the war in Afghanistan, succeeds in writing a convincing, accurate thriller because he too sticks with what he knows. His protagonist, as it happens, is an American foreign correspondent trying to get into Afghanistan from Pakistan. He is having predictable run-ins with his translator, al-Qaeda, Pakistani cooking, Afghan marksmanship and the CIA. This book is worth reading if only for the passage where the hero, Skelly, glimpses Osama bin Laden at a public hanging; the scene both convinces and frightens.

Authenticity and sense of place are what Henning Mankell does best: his dry, turbulent Swedish police officer, Kurt Wallander, has moped and investigated his way across southern Sweden for seven books-worth of investigations. In “Before the Frost” his successor is introduced—his daughter, Linda. Both she and her father become entangled in a plot where humans, domestic animals and swans are the victims of a deranged cult intent on punishing the world's wrongdoers.

However evil the enemy in these three novels, their authors lose neither restraint nor perspective. In “Old Boys”, Charles McCarry does. That is a pity, because he is a good writer who, as a former spy himself, knows exactly what he talks about,

Cold Monday
By Terence Strong



Pocket Books; 480 pages; £6.99

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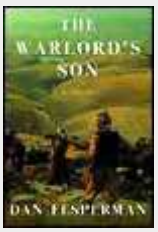
The Warlord's Son
By Dan Fesperman



Knopf; 336 pages; $23. Bantam Press; £12.99

Buy it at
Amazon.com
Amazon.co.uk

Before the Frost
By Henning Mankell. Translated by Ebba Segerberg

Harvill Press; 375 pages; £14.99. To be published in America by Norton in February 2005

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Amazon.com
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and he usually knows how to construct a good plot. Yet his tale of a bunch of retired American spies on a quest for stolen Russian nuclear warheads, along with an ancient scroll purporting to prove that Jesus was an unwitting Roman intelligence officer, pushes the limits: suffice to say that al-Qaeda, the SS and the Catholic Church get a look-in. Mr McCarry, of all people, should stick with what he knows.

Cold Monday.
By Terence Strong.
Pocket Books; 480 pages; £6.99

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Old Boys.
By Charles McCarry.
Overlook Press; 476 pages; $25.95. Weidenfeld & Nicolson; £16.99

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About sponsorship

Graham Greene

Ways of escape

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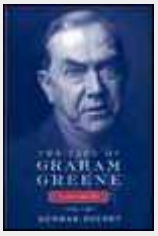
THE late Graham Greene was born 100 years ago on October 2nd. Each year at this time, a festival is held in his honour, at his birthplace, Berkhamsted School. There are talks and reminiscences from friends and luminaries, including Sir John Mortimer and David Lodge, and an appearance by Greene's rather egocentric official biographer, Norman Sherry.

The Life of Graham Greene, Volume Three: 1955-1991
By Norman Sherry



Viking; 800 pages; $39.95.
Jonathan Cape; £25.00

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Greene was made in Berkhamsted, a pleasant, leafy town in London's farthest-flung suburbs. At school, where his father was headmaster, he rebelled against the established church and all forms of militarism and sport. The psychoanalysis he underwent at 16 softened his sense of alienation, yet this compelling and compulsive novelist was always a mischievous figure, a gadfly delighting in mocking the establishment into which he was born. At the height of the cold war, he declared that the Soviet Union was a better place to live than the United States. He cheered on Marxist politicians (Salvador Allende and Fidel Castro), and embraced outsiders like Kim Philby, the Soviet spy with whom he had worked in MI6.

Yet, 13 years after his death, his politics seem ephemeral. Graham Greene is defined by his fiction, and by the films it has inspired—most recently, “The Quiet American” and “The End of the Affair”. Eight of the best novels are to be republished in Britain by Vintage on October 7th, with introductions by contemporary authors, including J.M. Coetzee, Paul Theroux and Zadie Smith. Greene, who was not easily surprised, might have raised an eyebrow at the news that his taut, shocking story of Pinkie, the psychopathic teenage gangster in “Brighton Rock”, has been turned into a musical, now being performed at the Almeida Theatre in London.

At Berkhamsted, Mr Sherry celebrates the publication of the third and final volume of his voluminous authorised biography of Greene, which he began in 1976. Mr Sherry, who is the reporter of the uncensored drama of Greene's life, is an odd sort of biographer. The start of this last volume tells of his astonishment at the immense sense of loss he himself felt on Greene's death in April 1991. The first illustration shows not the subject, but the biographer himself. He is on horseback following Greene's footsteps through Mexico, where the novelist in 1938 found the material for the story of the courageous and flawed priest in “The Power and the Glory”.

Even more doggedly, Mr Sherry visits the locations of all of Greene's novels written after 1955. This takes him to the source of some of the author's best work: to the Congo (“A Burnt-Out Case”), “Papa Doc” Duvalier's Haiti (“The Comedians”), Cuba (“Our Man in Havana”) and Paraguay (“The Honorary Consul”). We learn where and with whom Greene drank, which brothels he frequented, and where he smoked opium. His behaviour was rarely less than louche. Evelyn Waugh, a friend, called him a voluptuary.

Yet Greene never shirked the concept of good and evil. Indeed, he converted to Roman Catholicism in 1926 when he became “convinced of the probable existence of something we call God”. His Catholicism informs a persistent moral debate—though not quite in the way the Church intended. His priests are often weak, and Greene is no admirer of piety. Take the narrator in “The Heart of the Matter”, for example: “The truth, he thought, has never been of any real value to any human being. In human relations, kindness and lies are worth a thousand truths.”

Mr Sherry's Greene is a manic-depressive. Greene himself said that his behaviour was an escape from deep boredom that had chased him since his schooldays. Escape took many forms: travelling, writing,

and being in love, including multiple affairs, notably with Catherine Walston.

Mr Sherry has had exclusive access to Greene's letters and papers—indeed, his refusal to share these papers led to animosity in biographical circles. He deploys the correspondence of Greene and Walston to linger relentlessly over a sad and unfulfilled passion for her. Not unreasonably: it inspired “The End of the Affair”, the least detached and most emotional of Greene's novels.

In “A Sort of Life”, his autobiography that was published in 1971, Greene says that there is a splinter of ice at the heart of a writer. As Greene grew old, the ice melted. Mr Sherry describes a sentimental, wilful and argumentative old man. Possibly, he was disconcerted by his biographer, who seems never to have left him alone. Pages of questions from Mr Sherry lay unanswered beside his deathbed.

Was Greene's life worth three volumes and around 2,500 pages? It was. Mr Sherry has written an absorbing and exhaustive source book. Yet the life itself is lived most vividly in Graham Greene's own words.

The Life of Graham Greene, Volume Three: 1955-1991.
By Norman Sherry.
Viking; 800 pages; $39.95. Jonathan Cape; £25.00

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About sponsorship

London's Old Vic

Indigestible tract

Sep 30th 2004
From The Economist print edition

The best must surely be to come

Male menopause

SAY this for Kevin Spacey: the New York performer who has twice won an Oscar has rarely taken the easy route in his career. It is quite a task, for instance, to star, direct and, to a large extent, write a film biography of Bobby Darin, the American crooner who is not exactly a household name: “Beyond the Sea” will open in Britain and America at the end of November. That will be Mr Spacey's second film as director, following the little-seen “Albino Alligator” in 1996. Yet far from sitting idle before the film's release, Mr Spacey has been deeply involved at the head of a theatrical rebirth in London. That is where the actor this week opened his much-anticipated tenure as artistic director of the venerable Old Vic theatre.

Once a jewel of a playhouse, the Old Vic's lustre has become tarnished in recent years. Neither Sir Peter Hall nor Sir Jonathan Miller were able, during their respective reigns, to reinvent for contemporary audiences the glories of a stage once dominated by the likes of Sir John Gielgud, Dame Peggy Ashcroft and Richard Burton. Enter Mr Spacey, then, to show that a maverick outsider could succeed where the British have not—and to lend some old-fashioned stardust to south London.

For his initial choice of play, Mr Spacey might have taken a hardy perennial: something by Eugene O'Neill, perhaps, or Shakespeare. O'Neill, in particular, is a past favourite of Mr Spacey's. Though both writers feature high on the actor's wish list for future seasons, Mr Spacey, for now, has chosen to kick off his stage-directing career with a hitherto obscure Dutch drama called “Cloaca”. The early verdict is that, after this inauspicious opening venture, things can only look up.

On the face of it, “Cloaca”, which is scheduled to run until December 11th, sends out all the right signals. The play has only before been seen in the native Netherlands of Maria Goos, the dramatist. Mr Spacey has thus shown a willingness to cast an international net. He is also no doubt wise to stay off-stage on this first occasion, allowing the attendant buzz to be as much about the relaunch of a beloved theatrical building as it is about a Hollywood film star who has unexpectedly made London home. (Mr Spacey appeared at the Old Vic in 1998, in a brilliant revival of O'Neill's “The Iceman Cometh”, which is how he came to share in the English affection for this playhouse.)

But, oh dear: there is no getting around the limitations of a script that is given little help by Mr Spacey's slack directorial hand. “Cloaca” appears to aspire to being some kind of alternative version of “Art”, which, like “Cloaca”, is another dissection of male bonding in early middle age that was also written by a woman, in that case, Yasmina Reza. Yet Ms Goos's play turns out to be as phoney as Mr Spacey's aspirations for the Old Vic are evidently sincere. For two-and-a-half hours, four 40-something men attempt to rekindle early friendships, all the while analysing where their lives have gone awry. As for the title, cloaca is revealed to be at once a one-time password of sorts for these men, and a metaphor for the point at which they have converged. As both the Latin word for sewer and a zoological term for the end of a tract for bodily excretions, cloaca is code for what is abundantly clear: these guys are a mess.

Maybe Dutch audiences took something more revelatory away from a play that, in its English-language premiere, feels overwritten, predictable and mawkish. One can, virtually from the outset, guess the fate of the anxious, bespectacled Pieter (played by Stephen Tompkinson), the gay local-government worker whose cache of now-valuable paintings drives what passes for a plot. At the same time, Neil Pearson's

Maarten is instantly recognisable as an avant-garde theatre director: he is, after all, dressed in the requisite black. But why go on? Many cultural ventures that eventually proved to be formidable have faltered at the starting gate, and Mr Spacey has made it clear that he is committed to the Old Vic for some years to come. With that in mind, one can salute the overall enterprise while regretting the opener: the best, surely, is yet to come.

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Amazon worldwide bestsellers

The big book index

Sep 30th 2004
From The Economist print edition

A scientific view of the world

SCIENCE writing for the lay reader gets better and better, and the best explains even the most complex subjects without condescension. Books by that affable populariser, Bill Bryson, and by Richard Dawkins, evolutionist, predominate. But classic works continue to sell well, years after publication.

1. A Short History of Nearly Everything.
By Bill Bryson. *Broadway; 560 pages; $11.17. Black Swan; £6.29*

This irrepressible American enthusiast whizzes us through time and space, explaining not just what we know, but how we know it. Enlightening or aggravating, according to taste.

Click to buy from Amazon.com or Amazon.co.uk

2. The Ancestor's Tale: A Pilgrimage to the Dawn of Life.
By Richard Dawkins. *Houghton Mifflin; 520 pages; $19.04. Weidenfeld & Nicolson; £15*

A new chronicle of life, wonderfully illustrated, from this great evolutionist.

Click to buy from Amazon.com or Amazon.co.uk

3. Guns, Germs, and Steel. The Fates of Human Societies.
By Jared Diamond. *Norton; 512 pages; $11.86. Vintage; £6.29*

How geography and ecology have shaped civilisations, by an eminent physiologist.

Click to buy from Amazon.com or Amazon.co.uk

4. The Road to Reality: A Complete Guide to the Laws of the Universe.
By Roger Penrose. *Knopf; 1,000 pages; $27.20. Jonathan Cape; £18*

An extraordinary account of the underlying mathematics of the physical universe. Not for the lay reader.

Click to buy from Amazon.com or Amazon.co.uk

5. The Fabric of the Cosmos: Space, Time, and the Texture of Reality.
By Brian Greene. *Knopf; 569 pages; $19.69. Allen Lane; £17.50*

A tour of the universe, with everyday analogies to explain hard-to-grasp concepts.

Click to buy from Amazon.com or Amazon.co.uk

6. Stiff: The Curious Lives of Human Cadavers.
By Mary Roach. *Norton; 303 pages; $11.16. Penguin; £3.99*

What happens to human bodies donated for medical or forensic research.

Click to buy from Amazon.com or Amazon.co.uk

7. The Elegant Universe: Superstrings, Hidden Dimensions, and the Quest for the Ultimate Theory.
By Brian Greene. *Vintage; 464 pages; $10.61 and £8*

How superstring theory identifies nature's fundamental building blocks, and what it means for the future of science.

Click to buy from Amazon.com or Amazon.co.uk

8. The Selfish Gene.
By Richard Dawkins. *Oxford University Press; 366 pages; $10.47 and £8.99*

The author's best-known book reformulates the theory of chance mutation acting upon natural selection.

Click to buy from Amazon.com or Amazon.co.uk

9. A Brief History of Time: The Updated and Expanded Tenth Anniversary Edition.
By Stephen Hawking. *Bantam; 240 pages; $11.24 and £5.59*

A modern classic, now updated to include chapters on wormholes and time travel. Hold on to your hats.

Click to buy from Amazon.com or Amazon.co.uk

10. The Structure of Scientific Revolutions.
By Thomas S. Kuhn. *University of Chicago Press; 240 pages; $10.40 and £9.50*

A classic on the nature of scientific invention and change, first published in 1962.

Click to buy from Amazon.com or Amazon.co.uk

11. Eine kurze Geschichte von fast allem.
By Bill Bryson. *Goldmann Verlag; 672 pages; €24.90*

The bearded wonder's latest bestseller, in German.

Click to buy from Amazon.de

12. The End of Oil: On the Edge of a Perilous New World.
By Paul Roberts. *Houghton Mifflin; 389 pages; $17.68 and £13.04*

How to break our addiction to oil, and what will happen when the wells run dry. By an author on the more alarmist wing of the oil debate.

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13. Kosmos Himmelsjahr 2005.
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By Trevor Corson. *HarperCollins; 289 pages; $16.97 and £12.51*

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By Steven Pinker. *Norton; 672 pages; $12.57. Penguin; £7.19*

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Obituary

Nigel Nicolson

Sep 30th 2004
From The Economist print edition

Nigel Nicolson, writer and publisher, died on September 23rd, aged 87

Getty Images

HIS first view of Sissinghurst Castle was one Nigel Nicolson never forgot. It was a wet day in 1930; he was 13. With his mother, Vita Sackville-West, he had trudged round the ruins of a manor house and tower with a few rows of cabbages for a garden. “But we haven't got to live here, have we?” he asked.

He had to. His mother and his father, Harold Nicolson, had decided to make Sissinghurst their grand project. Harold designed it; Vita planted it; and Nigel and his brother, Ben, became the holiday labourers. Each day his father, who had been eminent in the diplomatic service, taught them how to dig ponds and clear brambles. Then at 6pm, between bath and bed, Nigel would visit his mother in her writing room. Wearily laying her pen aside, she would talk to him.

Vita and Harold were on the periphery of the Bloomsbury set they belonged to. The Bloomsberries passed through young Nigel's life like occasional exotic birds: Lady Ottoline Morrell, feathered like a witch, at dinner, or Virginia Woolf, thin and curious, peppering him with questions. He would go with Virginia on butterfly hunts, and showed her the family portraits at Knole when she was gathering material for “Orlando”.

All this might have been incidental to Mr Nicolson's life. For years he carved out his own, different, track. After war service in Tunisia, Italy and Austria, he joined an exiled Viennese Jew, George Weidenfeld, to publish *Contact* magazine and then, after 1950, to form the publishing house of Weidenfeld & Nicolson. At the same time he entered politics, becoming the Tory MP for Bournemouth in 1952. He wrote a biography of Field Marshal Earl Alexander of Tunis, under whom he had served, and always thought this his best book. Having famous parents was undoubtedly an advantage, he wrote later. It had opened doors for him. But “children can escape”.

They could not escape quite so easily. In 1962, after his mother's death, Mr Nicolson found a locked Gladstone bag in her writing room. In it was a notebook containing an account of her affair with Violet Trefusis. Letters from Violet, and from many other lovers, were stacked in a cupboard nearby. Ever since the publication of “Orlando” in 1928, it was known that Vita and Virginia Woolf had been lovers; unwittingly, Nigel himself had helped in the making of that “love letter”. His father, too, had had homosexual affairs, and yet his parents had stayed contentedly together.

The book he wrote in 1973 on the basis of those papers, “Portrait of a Marriage”, became a sensation, and he found himself enmeshed in the cogs of the Bloomsbury industry. He edited his father's diaries not once, but twice; he published his mother's letters and, in six volumes, the letters of Virginia Woolf. On tours of America, he would be introduced as the last survivor and heir of the Bloomsbury group.

The silver vase

He was not its last survivor, but he was its heir in unexpected ways. Between garden chores at Sissinghurst, Harold had dinned into him the importance of truthfulness, no matter how awkward: a Bloomsbury virtue in relationships, at least. Nigel took that attitude into both politics and publishing, and

made a name for himself by defying government.

He was billed as a Tory, but believed he should not commit his conscience until he had had experience of Parliament. This caused nothing but trouble in Bournemouth, his staunchly Tory seat beside the sea. He was the only Tory backbencher to support Sidney Silverman's bill to abolish hanging, and one of the few to refuse to back the Tory government over Suez. When Bournemouth's Tories at last got rid of him, in 1959, his father sent him a silver vase inscribed *Aliis licet, tibi non licet*: “Others may do it, but you must not”.

His constituents were all the more upset because, at the same time, Mr Nicolson was trying to publish “Lolita”, Nabokov's tale of a 12-year-old sex-kitten ensnaring a middle-aged man. He meant it as a test case to expose the absurdities of the Obscene Publications Act; but he never defended the book as full-heartedly as Lord Weidenfeld did. He could not decide whether it was bravely original, or pornography. Its sales saved his publishing house, but he knew that both his parents were appalled by it. That weighed with him.

His biggest test of conscience, however, came in a different case. Immediately after the war he had been involved, in Carinthia, in the forced repatriation of thousands of Yugoslavs and Cossacks. The British had sent them home knowing they would be killed; most of them had been. In 1992, in the course of a libel trial, Mr Nicolson was obliged to admit publicly that he, too, had lied to the Yugoslavs about their fate. Realising they had been betrayed, they hammered desperately on the walls of the cattle trucks. It was, he said, “the most horrible experience of my life”.

It occurred to some that he might have betrayed his own parents almost as cruelly. He had not needed to unlock the Gladstone bag and scatter their infidelities to the world. But Mr Nicolson felt sure his mother had meant the papers to be published, and that the story of his parents' marriage would be an inspiration to others. As their custodian, he sat in the Sissinghurst gazebo with a tranquil heart.

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Overview

Sep 30th 2004
From The Economist print edition

Thanks partly to news of rebel attacks in Nigeria, **oil prices** rose above $50 a barrel for the first time ever and then fell back.

America's economic growth in the second quarter was revised up to an annualised rate of 3.3%, half a percentage point more than the previous estimate. In the year to the second quarter, the economy grew by 4.8%, compared with 4.7% in the previous estimate, helped by higher net exports than originally reported.

The Conference Board's measure of American **consumer confidence** slipped unexpectedly to 96.8 in September from 98.7 in August. Respondents said that jobs were harder to get. Sales of **new homes** surged by 9.4% in August to 1.184 million, buoyed by mortgage rates that remained low even as the Federal Reserve raised short-term rates. Orders for **durable goods**, which are often seen as a leading indicator of employment and economic growth, fell by 0.5% in August, after rising by more than 1.0% in each of the previous two months. A fall in aircraft orders played a big part in the decline.

Industrial production in **Japan** grew by a disappointing 0.3% in August, slightly less than economists had predicted.

Consumer prices in **Germany** fell by 0.3% in September, pushed down by cheaper clothing, food and hotels, bringing the year-on-year inflation rate down to 1.8%. The IFO confidence index slipped slightly to 95.2 in September, indicating weakness in the economic recovery. German wages rose by just 0.5% in the year to July, down from 1.5% in the year to June.

Austria's economy grew by 0.9% in the second quarter, a year-on-year rise of 1.9%, owing mostly to exports rather than consumer demand. Industrial production rose by 6.1% in the year to July, up from 5.9% in the year to June.

Producer prices in **France** edged up by 0.5% in both July and August and have risen by 2.8% in the year to August. In **Spain**, producer prices rose by 0.6% in August, and are up by 4.4% in the year to August.

Sweden's economy grew by 3.6% in the year to the second quarter. Producer prices rose by 2.0% in the year to August. Retail sales surged by 1.9% in August, and by 6.4% in the year to August. The government's delivery of tax refunds is likely to have encouraged the shopping spree.

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Output, demand and jobs

Sep 30th 2004
From The Economist print edition

% change on year ago

	GDP latest	GDP qtr*	The Economist poll GDP forecasts 2004	The Economist poll GDP forecasts 2005	Industrial production latest	Retail sales (volume) latest	Unemployment % rate latest	Unemployment % rate year ago
Australia	+ 4.1 Q2	+ 2.5	+ 3.6	+ 3.3	– 1.1 Q1	+ 7.9 Q2	5.7 Aug	6.2
Austria	+ 1.9 Q2	+ 3.6	+ 1.6	+ 2.1	+ 6.1 Jul	+ 5.8 Jun	4.2 Aug	4.5
Belgium	+ 2.7 Q2	+ 3.0	+ 2.4	+ 2.1	+ 1.5 Jul	+ 4.4 Jun	13.2 Aug†	13.3
Britain	+ 3.6 Q2	+ 3.6	+ 3.4	+ 2.7	+ 0.1 Jul	+ 6.5 Aug	4.7 Jul††	5.1
Canada	+ 3.0 Q2	+ 4.3	+ 3.0	+ 3.4	+ 5.0 Jun	+ 3.1 Jun	7.2 Aug	8.0
Denmark	+ 2.5 Q2	+ 0.9	+ 2.1	+ 2.3	+ 0.7 Jul	+ 4.9 Jul	6.2 Jul	6.0
France	+ 2.8 Q2	+ 2.8	+ 2.4	+ 2.2	+ 2.5 Jul	+ 2.1 Jul	9.9 Aug	9.8
Germany	+ 2.0 Q2	+ 1.9	+ 1.5	+ 1.7	+ 2.2 Jul	nil Jul	10.6 Aug§	10.6
Italy	+ 1.2 Q2	+ 1.1	+ 1.2	+ 1.7	– 1.2 Jul	– 0.8 Jun	8.5 Apr	8.7
Japan	+ 4.2 Q2	+ 1.3	+ 4.5	+ 2.3	+ 9.9 Aug	+ 0.8 Jul	4.9 Jul	5.3
Netherlands	+ 1.3 Q2	– 0.4	+ 1.3	+ 1.7	+ 0.2 Jul	– 0.7 Jun‡	6.2 Aug**	5.3
Spain	+ 2.6 Q2	+ 2.0	+ 2.8	+ 2.8	+ 0.4 Jul	+ 3.0 Jul	11.0 Jul	11.3
Sweden	+ 3.6 Q2	+ 4.0	+ 3.0	+ 2.7	– 0.1 Jul	+ 6.4 Aug	5.5 Aug†	5.4
Switzerland	+ 2.0 Q2	+ 1.6	+ 1.9	+ 2.0	+ 4.3 Q2	– 0.8 Jul	3.7 Aug†	3.6
United States	+ 4.8 Q2	+ 3.3	+ 4.3	+ 3.4	+ 5.2 Aug	+ 5.5 Jul	5.4 Aug	6.1
Euro area	+ 2.0 Q2	+ 2.1	+ 1.8	+ 2.0	+ 2.4 Jul	+ 1.1 Jul	9.0 Jul	8.9
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*							
Finland	+ 2.7 Q2	+ 2.9	na	na	+ 7.2 Aug	+ 5.1 Jul	8.0 Aug†	7.7
Greece	+ 3.9 Q2	– 0.6	na	na	– 0.6 Jul	+ 5.5 Jun	na	na
Iceland	+ 6.2 Q2	na	na	na	na	na	3.0 Jul†	3.0
Ireland	+ 6.1 Q1	na	na	na	+ 6.4 Jul	+ 1.2 Jul	4.3 Aug	4.7
Luxembourg	+ 2.12003	na	na	na	– 1.2 Dec	+ 3.4 Apr	4.0 Jul	3.6
New Zealand	+ 6.0 Q2	+ 4.6	na	na	+ 5.5 Q1	+ 6.8 Q2	4.0 Q2	4.7
Norway	+ 4.1 Q2	+ 5.0	na	na	+ 3.5 Jul	+ 3.6 Aug	4.6 Q2	4.7
Portugal	+ 1.5 Q2	+ 4.7	na	na	– 3.4 Jul	+ 2.8 Jul	6.3 Q2†	6.1

*% change on previous quarter at an annual rate. †Not seasonally adjusted. ‡New series. ††May-Jul; claimant count rate 2.7% in Aug. §EU harmonised rate 9.9% in Aug. **Jun-Aug.

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Prices and wages

Sep 30th 2004
From The Economist print edition

% change on year ago

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2004	2005	latest		year ago	latest		year ago
Australia	+ 2.5	Q2	+ 2.7	+ 2.4	+ 2.6	+ 2.8	Q2	+ 0.2	+ 2.9	Q2	+ 5.5
Austria	+ 2.4	Aug	+ 1.2	+ 1.6	+ 1.5	+ 6.3	Aug	+ 1.3	+ 1.9	Aug	+ 2.3
Belgium	+ 2.0	Sep	+ 1.8	+ 1.9	+ 1.6	+ 5.8	Aug	– 1.4	+ 2.2	Jul	+ 1.9
Britain	+ 1.3	Aug*	+ 1.4	+ 1.5	+ 1.8	+ 2.6	Aug	+ 1.5	+ 3.8	Jul†	+ 3.3
Canada	+ 1.9	Aug	+ 2.0	+ 2.0	+ 2.2	+ 4.9	Aug	– 1.9	+ 1.5	Jul	+ 5.1
Denmark	+ 1.2	Aug	+ 1.7	+ 1.2	+ 1.8	+ 3.1	Aug	– 0.3	+ 3.1	Q2	+ 3.8
France	+ 2.4	Aug	+ 1.9	+ 2.2	+ 1.6	+ 2.8	Aug	+ 0.5	+ 2.8	Q2	+ 2.7
Germany	+ 1.8	Sep	+ 1.1	+ 1.7	+ 1.3	+ 4.2	Aug	+ 0.5	+ 0.5	Jul	+ 1.4
Italy	+ 2.1	Sep	+ 2.8	+ 2.3	+ 2.1	+ 3.3	Jul	+ 1.3	+ 2.6	Aug	+ 2.6
Japan	– 0.1	Jul	– 0.2	– 0.1	+ 0.2	+ 1.7	Aug	– 0.7	+ 1.9	Jul	+ 3.6
Netherlands	+ 1.1	Aug	+ 2.1	+ 1.4	+ 1.4	+ 4.9	Jul	+ 0.2	+ 1.2	Aug	+ 2.5
Spain	+ 3.3	Aug	+ 3.0	+ 2.9	+ 2.7	+ 4.4	Aug	+ 1.1	+ 3.1	Q2	+ 4.2
Sweden	+ 0.6	Aug	+ 1.7	+ 0.8	+ 1.5	+ 2.0	Aug	– 1.7	+ 1.1	Jun	+ 3.5
Switzerland	+ 0.9	Sep	+ 0.5	+ 0.7	+ 1.1	+ 1.5	Aug	– 0.3	+ 1.4	2003	+ 1.8
United States	+ 2.7	Aug	+ 2.2	+ 2.7	+ 2.4	+ 3.4	Aug	+ 3.5	+ 2.3	Aug	+ 2.6
Euro area	+ 2.3	Aug	+ 2.1	+ 2.1	+ 1.7	+ 2.8	Jul	+ 1.1	+ 2.2	Q2	+ 3.3
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 0.4	Aug	+ 0.6	na	na	+ 1.8	Aug	+ 0.3	+ 3.5	Q2	+ 4.4
Greece	+ 2.7	Aug	+ 3.3	na	na	+ 2.3	Jul	+ 2.9	na		na
Iceland	+ 3.4	Sep	+ 2.2	na	na	+ 7.2	Sep	+ 3.6	+ 5.2	Aug	+ 5.7
Ireland	+ 2.6	Aug	+ 3.2	na	na	– 0.4	Aug	– 7.8	+ 3.8	Q2	+ 8.0
Luxembourg	+ 2.3	Aug	+ 2.0	na	na	+ 9.6	Jul	+ 0.7	– 0.4	Dec	+ 0.7
New Zealand	+ 2.4	Q2	+ 1.5	na	na	+ 1.5	Q2	– 1.9	+ 2.3	Q2	+ 2.3
Norway	+ 1.0	Aug	+ 2.1	na	na	+16.4	Aug	+ 6.1	+ 4.5	Q2	+ 5.4
Portugal	+ 2.3	Aug	+ 2.8	na	na	+ 4.1	Aug	+ 0.1	+ 1.4	Jul	– 2.5

*New series. RPI inflation rate 3.2% in Aug. †May-Jul.

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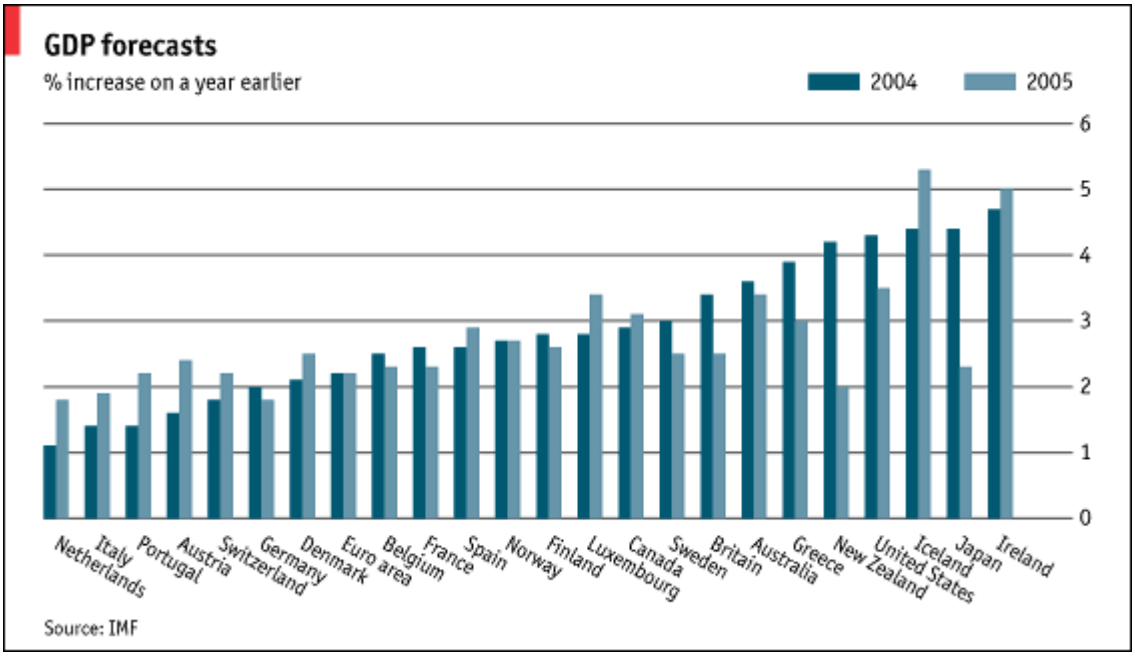
GDP forecasts

Sep 30th 2004
From The Economist print edition



Although world output will grow in 2004 by 5.0%, the fastest for nearly 30 years, growth in advanced economies will be a more modest 3.6%. The International Monetary Fund forecasts that the upswing in the advanced world will taper away to 2.9% in 2005. GDP in both America and Japan will expand more slowly next year than in 2004. The euro area will carry on growing in 2005 at this year's modest pace of 2.2%, predicts the IMF.

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Money and interest rates

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	Money supply* % change on year ago			Interest rates % p.a. (Sep 29th 2004)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	+ 5.6	+10.2	Aug	5.42	4.86	5.10	5.41	5.37	6.18
Britain	+ 5.1	+ 9.7	Aug	4.88	3.66	4.67	4.82	4.53	5.43
Canada	+10.5	+ 9.1	Aug	2.44	2.59	3.09	4.57	4.56	6.02
Denmark	+ 9.5	+11.1	Aug	2.25	2.18	2.80	4.06	4.13	5.35
Japan	+ 3.8	+ 1.9	Aug	0.02	0.01	0.12	1.43	1.40	1.48
Sweden	+ 1.1	+ 1.5	Aug	1.98	2.70	2.74	4.25	4.46	2.84
Switzerland	+ 0.6	+ 2.0	Aug	0.71	0.24	1.14	2.62	2.50	2.44
United States	+ 4.7	+ 4.4	Aug	1.82	1.05	2.60	4.09	3.94	5.59
Euro area†	+ 9.3	+ 5.5	Aug	2.15	2.12	2.55	3.95	3.94	3.78

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. †Germany for bonds. Benchmarks: US 30-year 4.87%, Japan No. 263 1.42%. Central bank rates: US fed funds 1.75%, ECB refinancing 2.00%, BOJ overnight call 0.001%, BOE repo 4.75%. Sources: Commerzbank, Danske Bank, J.P. Morgan Chase, Royal Bank of Canada, Stockholmsbörsen, UBS, Global Insight, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

Sep 30th 2004
From The Economist print edition

1995=100

	Sep 21st	Sep 28th*	% change on one month	% change on one year
Dollar index				
All items	87.9	88.4	– 1.9	+ 8.3
Food	80.7	80.6	– 4.1	– 1.9
Industrials				
All	97.6	99.1	+ 0.6	+22.2
Nfa†	85.9	85.5	– 8.3	– 0.8
Metals	107.5	110.5	+ 7.4	+44.0
Sterling index				
All items	77.3	77.0	– 2.6	– 0.7
Euro index				
All items	94.3	94.4	– 3.2	+ 2.4
Yen index				
All items	102.0	104.8	– 0.4	+ 8.0
Gold				
$ per oz	408.53	411.13	+ 0.2	+ 6.7
West Texas Intermediate				
$ per barrel	46.93	49.90	+18.4	+71.3

* Provisional. † Non-food agriculturals.

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Stockmarkets

Sep 30th 2004
From The Economist print edition

Market indices

	Sep 29th	2004 high	2004 low	% change on one week	% change on record high	% change on Dec 31st 2003 in local currency	% change on Dec 31st 2003 in $ terms
Australia (All Ordinaries)	3,667.1	3,667.1	3,274.9	+ 0.4	nil	+10.9	+ 5.2
Austria (ATX)	2,051.0	2,051.0	1,568.9	+ 0.6	nil	+32.7	+29.6
Belgium (Bel 20)	2,690.9	2,690.9	2,244.2	+ 1.0	-26.9	+19.9	+17.1
Britain (FTSE 100)	4,588.1	4,608.4	4,287.0	- 0.1	-33.8	+ 2.5	+ 3.0
Canada (Toronto Composite)	8,634.1	8,898.8	8,123.5	+ 0.6	-24.2	+ 5.0	+ 6.8
Denmark (KBX)	249.9	249.9	219.0	+ 1.7	-17.2	+17.0	+14.3
France (SBF 250)	2,518.6	2,594.4	2,386.1	- 0.1	-42.6	+ 4.4	+ 2.0
(CAC 40)	3,682.7	3,811.4	3,465.3	- 0.3	-46.8	+ 3.5	+ 1.1
Germany (DAX)	3,920.4	4,151.8	3,647.0	- 0.6	-51.4	- 1.1	- 3.5
Italy (BCI)	1,327.2	1,340.3	1,239.5	nil	-39.2	+ 5.6	+ 3.1
Japan (Nikkei 225)	10,786.1	12,163.9	10,365.4	- 2.1	-72.3	+ 1.0	- 2.3
(Topix)	1,089.0	1,217.9	1,022.6	- 2.2	-62.2	+ 4.3	+ 0.9
Netherlands (AEX)	325.3	364.8	310.7	- 1.3	-53.6	- 3.7	- 5.9
Spain (Madrid SE)	852.5	881.7	804.4	+ 0.4	-25.6	+ 5.5	+ 3.0
Sweden (Affarsvarlden Gen)	208.4	218.1	188.5	+ 1.0	-47.9	+10.6	+ 8.4
Switzerland (Swiss Market)	5,531.4	5,934.4	5,309.8	- 0.7	-34.2	+ 0.8	- 1.1
United States (DJIA)	10,136.2	10,737.7	9,814.6	+ 0.3	-13.5	- 3.0	- 3.0
(S&P 500)	1,114.8	1,157.8	1,063.2	+ 0.1	-27.0	+ 0.3	+ 0.3
(NASDAQ Comp)	1,893.9	2,153.8	1,752.5	+ 0.4	-62.5	- 5.5	- 5.5
Europe (FTSE Eurotop 300)*	993.8	1,026.2	940.9	- 0.3	-41.7	+ 3.7	+ 1.3
Euro area (FTSE Ebloc 100)*	838.1	888.3	787.2	- 0.3	-45.9	+ 0.8	- 1.6
World (MSCI)†	1,044.9	1,085.8	997.0	nil	-27.9	+ 0.8	+ 0.8
World bond market (Citigroup)‡	610.7	619.5	575.1	+ 0.2	- 1.4	+ 1.2	+ 1.2

*In euro terms. †Morgan Stanley Capital International index includes individual markets listed above plus eight others, in $ terms.
‡Citigroup World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

Sep 30th 2004
From The Economist print edition

	Trade balance*, $bn latest 12 months		Current account $bn latest 12 mths		The Economist poll % of GDP, forecast 2004	2005	Exchange rate trade-weighted† 1990=100 Sep 29th	year ago	Currency units per $ Sep 29th	year ago	per £	per euro	per ¥100	Budget balance % of GDP 2004‡
Australia	− 17.0	Aug	− 34.2	Q2	− 5.6	− 4.9	84.5	83.0	1.40	1.47	2.52	1.72	1.26	0.5
Austria	− 1.5	Jul	− 1.9	Jul	− 0.4	− 0.5	103.0§	103.0	0.81	0.85	1.46	–	0.73	-1.3
Belgium	+ 20.3	Jul	+ 12.2	Mar	+ 3.2	+ 3.5	103.1§	103.0	0.81	0.85	1.46	–	0.73	-0.2
Britain	− 97.5	Jul	− 41.7	Q2	− 2.3	− 2.3	103.1	99.2	0.56	0.60	–	0.68	0.50	-2.9
Canada	+ 49.3	Jul	+ 23.8	Q2	+ 2.4	+ 2.1	90.8	86.9	1.27	1.35	2.29	1.56	1.15	1.2
Denmark	+ 10.4	Jul	+ 7.0	Jul	+ 2.7	+ 2.6	106.6	106.4	6.04	6.34	10.9	7.44	5.45	0.9
France	+ 1.9	Jul††	− 0.7	Jul	+ 0.5	+ 0.6	106.5§	106.4	0.81	0.85	1.46	–	0.73	-3.8
Germany	+186.4	Jul	+ 95.1	Jul	+ 2.8	+ 2.8	104.3§	104.1	0.81	0.85	1.46	–	0.73	-3.7
Italy	+ 3.3	Jul	− 14.0	Jul	− 1.0	− 1.0	76.0§	75.9	0.81	0.85	1.46	–	0.73	-3.1
Japan	+133.4	Jul	+165.8	Jul	+ 3.5	+ 3.6	132.3	135.9	111	111	199	136	–	-7.1
Netherlands	+ 33.7	Jul	+ 20.7	Q2	+ 2.7	+ 2.9	102.6§	102.5	0.81	0.85	1.46	–	0.73	-3.1
Spain	− 62.4	Jun	− 33.4	Jun	− 2.8	− 2.9	77.1§	77.1	0.81	0.85	1.46	–	0.73	0.3
Sweden	+ 22.9	Aug	+ 23.4	Q2	+ 6.3	+ 6.1	82.3	81.8	7.35	7.72	13.2	9.05	6.63	0.2
Switzerland	+ 8.2	Aug	+ 44.5	Q1	+10.9	+10.6	112.1	111.5	1.26	1.31	2.27	1.55	1.14	-1.6
United States	−598.3	Jul	−571.9	Q2	− 5.1	− 5.0	95.9	99.6	–	–	1.80	1.23	0.90	-4.7
Euro area	+111.8	Jul	+ 61.5	Jul	+ 0.5	+ 0.5	91.4	90.2	0.81	0.85	1.46	–	0.73	-2.8
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*													
Finland	+ 14.8	Jul	+ 11.2	Jul	na	na	82.2§	82.0	0.81	0.85	1.46	–	0.73	1.6
Greece	− 28.1	Jun	− 11.1	Jul	na	na	59.6§	59.6	0.81	0.85	1.46	–	0.73	-3.2
Iceland	− 0.5	Aug	− 0.6	Q2	na	na	95.2**	99.1	71.2	76.0	128	87.7	64.3	0.2
Ireland	+ 42.4	Jul	− 2.1	Q1	na	na	94.2§	94.7	0.81	0.85	1.46	–	0.73	-0.5
Luxembourg	− 3.9	Jun	+ 3.2	Q1	na	na	103.1§	103.0	0.81	0.85	1.46	–	0.73	-1.8
New Zealand	− 2.4	Aug	− 3.9	Q2	na	na	106.8	98.1	1.50	1.67	2.69	1.84	1.35	2.9
Norway	+ 30.2	Aug	+ 31.2	Jul	na	na	96.4	97.7	6.78	7.01	12.2	8.36	6.12	10.4
Portugal	− 16.9	Jun	− 10.0	Jul	na	na	93.6**	93.8	0.81	0.85	1.46	–	0.73	-3.8

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †Bank of England except §IMF, July average. ‡OECD forecast. ††New series. **IMF, May average.

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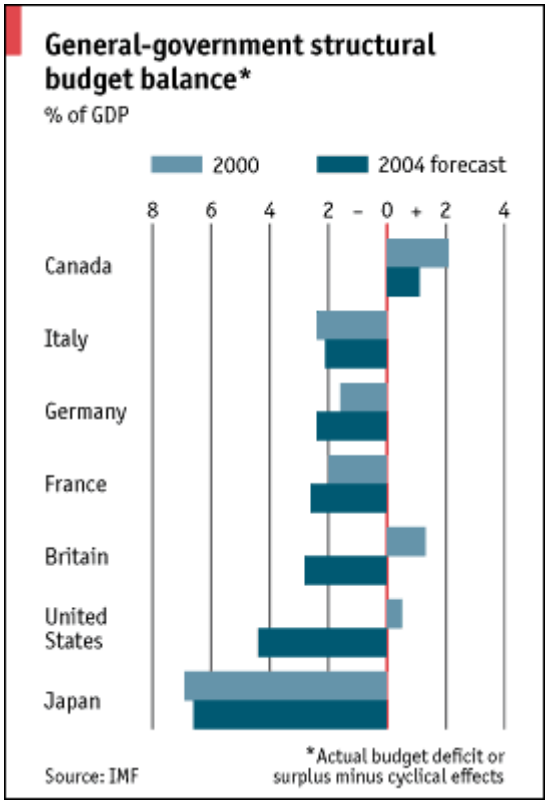
About sponsorship

General-government structural budget balance

Sep 30th 2004
From The Economist print edition



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Overview

Sep 30th 2004
From The Economist print edition

India's GDP grew by 7.4% year-on-year in the three months to June. This was down from 8.2% in the first quarter, but still beat most forecasts.

In **Singapore**, industrial output fell by 1.1% in August. The year-on-year growth in output fell to 5.3%, from 19.0% in July.

Hong Kong's consumer prices rose by a modest 0.8% in the year to August.

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GDP per person

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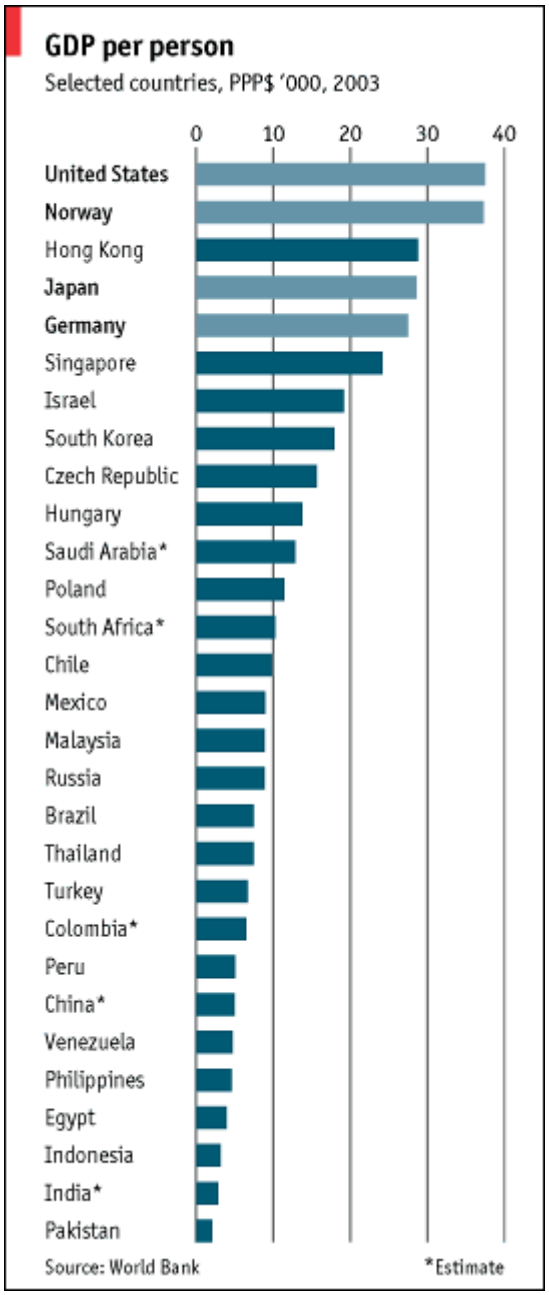
Measured on a purchasing power parity (PPP) basis, which takes account of exchange-rate fluctuations, Singapore's GDP per head in 2003 was only around 14% less than Germany's, according to recent estimates from the World Bank. Hong Kong remains the richest emerging economy regularly tracked by *The Economist*. It had an income per head in 2003 of $28,810, compared with America's $37,500. China has leapfrogged Venezuela since last year's estimates were published. Its income per head now stands at almost $5,000. India, despite rapid growth, still trails Indonesia.



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Economy

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	% change on year ago						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+ 9.6	Q2	+15.9	Aug	+ 5.3	Aug	+16.2	Aug	+45.9	2003	483.0	Jul
Hong Kong	+12.1	Q2	+ 1.1	Q2	+ 0.8	Aug	−13.6	Aug	+13.6	Q2	118.5	Aug
India	+ 7.4	Q2	+ 7.9	Jul	+ 3.2	Jul	−18.5	Aug	+ 8.7	Q1	112.1	Aug
Indonesia	+ 4.3	Q2	+15.0	Jun	+ 6.7	Aug	+24.8	Jul	+ 3.9	Q2	33.6	Jul
Malaysia	+ 8.0	Q2	+ 9.9	Jul	+ 1.4	Aug	+20.1	Jul	+13.6	Q2	54.2	Aug
Philippines	+ 6.2	Q2	− 0.4	Jul	+ 6.3	Aug	− 1.6	Jul	+ 3.9	Mar	12.7	Aug
Singapore	+12.5	Q2	+ 5.3	Aug	+ 1.6	Aug	+16.0	Aug	+28.4	Q2	101.3	Aug
South Korea	+ 5.5	Q2	+12.8	Jul	+ 4.8	Aug	+29.2	Aug	+27.3	Aug	170.4	Aug
Taiwan	+ 7.7	Q2	+ 8.8	Aug	+ 2.5	Aug	+11.6	Aug	+25.8	Q2	231.6	Aug
Thailand	+ 6.3	Q2	+ 6.1	Aug	+ 3.1	Aug	+ 1.3	Aug	+ 6.7	Aug	42.4	Jul
Argentina	+ 7.0	Q2	+ 8.4	Aug	+ 5.2	Aug	+12.8	Jul	+ 6.1	Q1	18.1	Aug
Brazil	+ 5.7	Q2	+ 9.6	Jul	+ 7.2	Aug	+31.7	Aug	+ 9.7	Aug	49.6	Aug
Chile	+ 5.1	Q2	+ 5.8	Jul	+ 1.6	Aug	+ 7.4	Aug	+ 1.2	Q2	15.8	Aug
Colombia	+ 4.3	Q2	+ 4.9	Jul	+ 5.9	Aug	+ 0.1	Jun	− 1.6	Q1	12.0	Aug
Mexico	+ 3.9	Q2	+ 3.8	Jul	+ 4.8	Aug	− 5.8	Aug	− 6.7	Q2	60.3	Jul
Peru	+ 3.8	Jul	+ 8.4	Jul	+ 4.6	Aug	+ 1.8	Jul	− 0.7	Q2	10.2	Aug
Venezuela	+13.6	Q2	+32.2	Jun	+21.9	Aug	+20.3	Q2	+14.0	Q2	18.0	Jun
Egypt	+ 4.3	2004†	+ 2.6	2003†	+16.5	May‡	− 7.5	Q2	+ 3.7	Q2	13.3	May
Israel	+ 3.0	Q2	+ 1.9	Jul	+ 0.5	Aug	− 6.2	Aug	+ 0.1	Q2	26.1	Aug
South Africa	+ 2.5	Q2	+ 5.5	Jul	+ 1.0	Aug	− 0.2	Jul	− 3.5	Q2	10.4	Aug
Turkey	+13.4	Q2	+12.8	Jul	+10.0	Aug	−31.2	Aug	−11.6	Jul	32.4	Jul
Czech Republic	+ 4.1	Q2	+11.0	Jul	+ 3.4	Aug	− 2.1	Jul	− 6.2	Q2	26.3	Aug
Hungary	+ 4.0	Q2	+ 7.6	Jul	+ 7.2	Aug	− 3.6	Apr	− 8.4	Apr	12.8	Aug
Poland	+ 6.1	Q2	+13.5	Aug	+ 4.6	Aug	− 5.3	Jul	− 4.0	Jul	34.6	Jul
Russia	+ 7.4	Q2	+ 6.8	Aug	+11.3	Aug	+69.5	Jul	+38.4	Q2	84.9	Aug
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Estonia	+ 5.9	Q2	+ 6.0	Aug	+ 4.0	Aug	− 2.4	Jul	− 1.5	Q2	1.4	Jul
Latvia	+ 7.7	Q2	+ 7.8	Jul	+ 7.8	Aug	− 2.5	Jul	− 1.4	Jul	1.6	Jul
Lithuania	+ 6.9	Q2	na		+ 2.2	Aug	− 3.1	Jul	− 1.8	Q2	3.3	Jul
Slovakia	+ 5.4	Q2	+ 0.7	Jul	+ 7.2	Aug	− 0.7	Jul	− 0.7	Jul	12.8	Jul
Slovenia	+ 4.6	Q2	+ 3.0	Jul	+ 3.3	Sep	− 0.9	Jul	− 0.1	Jul	7.9	Jun
Pakistan	+ 6.4	2004†	+24.8	May	+ 9.2	Aug	− 3.7	Aug	+ 1.8	Q2	11.2	Jun
Saudi Arabia	+ 7.2	2003	na		+ 0.2	Jun	+61.2	2003	+29.7	2003	22.2	Aug

*Excluding gold, except Singapore; IMF definition. †Year ending June. ‡New series, % change Jan-May annualised.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Economist Intelligence Unit; Reuters; J.P. Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Deutsche Bank

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Financial markets

Sep 30th 2004
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	Sep 29th		Dec 31st 2003	
	Sep 29th	year ago	Sep 29th	% p.a.		one week	in local currency	in $ terms
China	8.28	8.28	14.9	3.15	1,489.7	nil	– 5.1	– 5.1
Hong Kong	7.80	7.74	14.0	1.08	12,950.8**	– 2.4	+ 3.0	+ 2.5
India	46.0	45.6	82.7	4.90	5,527.6	– 1.6	– 5.3	– 6.0
Indonesia	9,186	8,384	16,534	7.50	812.9	– 0.7	+ 17.5	+ 7.7
Malaysia	3.80	3.80	6.84	2.87	846.7	– 1.1	+ 6.6	+ 6.6
Philippines	56.3	54.8	101.4	7.44	1,742.1	+ 0.8	+ 20.8	+ 19.1
Singapore	1.69	1.73	3.04	1.38	1,974.4	– 1.0	+ 11.9	+ 12.4
South Korea	1,153	1,152	2,074	3.53	832.1††	– 0.4	+ 2.6	+ 6.1
Taiwan	33.9	33.8	60.9	1.20	5,809.8	– 2.7	– 1.4	– 1.1
Thailand	41.5	39.7	74.7	1.82	636.6	– 4.1	– 17.6	– 21.3
Argentina	2.99	2.92	5.38	5.63	1,147.1	+ 5.6	+ 7.0	+ 5.0
Brazil	2.86	2.91	5.15	16.24	23,208.4	+ 2.0	+ 4.4	+ 5.1
Chile	607	659	1,093	1.92	8,555.7	+ 2.0	+ 16.6	+ 13.8
Colombia	2,597	2,912	4,674	7.72	3,560.9	– 1.8	+ 52.6	+ 63.3
Mexico	11.4	11.0	20.6	7.61	10,980.3	+ 1.9	+ 24.8	+ 22.7
Peru	3.34	3.48	6.02	2.80	3,224.3	+ 6.2	+ 32.4	+ 37.2
Venezuela	2,535§	1,598	4,562	11.94	30,054.9	+ 3.0	+ 35.4	+ 52.3
Egypt	6.24	6.12	11.24	10.74	19,826.0	– 0.4	+ 70.4	+ 68.2
Israel	4.48	4.43	8.06	1.00	559.0**	– 1.6	+ 4.6	+ 2.6
South Africa	6.44	6.90	11.6	7.35	11,709.7	+ 1.3	+ 12.7	+ 16.8
Turkey	1,505,000	1,390,000	2,708,850	23.90	22,219.9	+ 3.4	+ 19.3	+ 11.4
Czech Republic	25.7	27.3	46.2	2.81	875.4	+ 1.8	+ 32.8	+ 32.8
Hungary	201	217	362	10.84	12,556.2	+ 2.0	+ 33.9	+ 38.2
Poland	3.55	3.91	6.39	7.15	25,190.3	nil	+ 21.0	+ 27.5
Russia	29.2	30.5	52.6	13.00	631.6‡	+ 1.1	+ 11.2	+ 11.3
EMF (MSCI)*	1.00	1.00	1.80	na	461.7	– 0.2	+ 4.3	+ 4.3
EMBI+†	1.00	1.00	1.80	na	313.5	– 0.8	+ 6.3	+ 6.3

*Emerging Mkts Free. †J.P. Morgan Chase's Emerging Mkts Bond Index Plus. ‡In $ terms. §Floating exchange rate. **Sep 28th. ††Sep 24th.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Economist Intelligence Unit; Reuters; J.P. Morgan Chase; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; FIEL; EFG-Hermes; Bank Leumi Le-Israel; Standard Bank Group; Akbank; Deutsche Bank

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